The Interactions between Chinese Tax Incentives and WTO's Subsidy Rules against the Backgrund of EU State Aid

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Proefschrift

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List of Abbreviations

ALL	Administrative Litigation Law
ARL	Administrative Reconsideration Law
AOA	Agreement on Agriculture
APEC	Asia-Pacific Economic Cooperation
ASCM	Agreement on Subsidies and Countervailing Measures
AUCL	Anti-Unfair Competition Law
BT	Business Tax
CCP	Chinese Communist Party
CEZ	Comprehensive Experiment Zone
CJEU	Court of Justice of the European Union
COEA	Coastal Open Economic Area
DSB	Dispute Settlement Body
ECtHR	European Court of Human Rights
EEC	European Economic Community
EIT	Enterprise Income Tax
EC	European Communities
EP	European Parliament
ETDZ	Economic and Technological Development Zone
EU	European Union
FDI	Foreign Direct Investment
FE	Foreign Enterprise
FEITL	Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises
FIE	Foreign Invested Enterprise
FTA	Free Trade Agreement
FTZ	Free Trade Zone
FSC	Foreign Sale Corporation
GAC	General Administration of Customs
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GBER	General Block Exemption Regulation
GDP	Gross Domestic Product
High-tech	High Technology
IC	Integrated Circuit
LATC	Law of the People's Republic of China Concerning the Tax Administration and Tax Collection
MNE	Multinational Enterprise
MoF	Ministry of Finance
NAO	National Audit Office
NPC	National People's Congress
OECD	Organisation for Economic Co-operation and Development
PRC	People's Republic of China

RIEITL	Regulation on the Implementation of the Enterprise Income Tax Law
R&D	Research and Development
R&D&I	Research and Development and Innovation
SAAP	State Aid Action Plan
SAM	State Aid Modernization
SASAC	Assets Supervision and Administration Commission
SAT	State Administration of Taxation
SEZ	Special Economic Zone
SLE	Small and Low-profit Enterprise
SOE	State-Owned Enterprise
SPC	Supreme People's Court
TAXE	European Parliament Committee on Tax Rulings and Other Measures Similar in Nature or Effect
TFEU	Treaty on the Functioning of the European Union
US	United States
VAT	Value Added Tax
WTO	World Trade Organization
WDS	Western Development Strategy

Chapter 1 Introduction

1.1 Research background

In the context of international trade, the use of subsidies is becoming an important issue. Politically, governments tend to use subsidies to achieve policy goals, such as correcting market failures, supporting infant industries, and decreasing regional disparity, etc. Economically, subsidies cause both beneficial and adverse effects. They contribute to the achievement of governmental goals in a certain degree. For instance, subsidies to small and medium sized enterprises create incentives for them to lower the costs and increase production, thus stimulating the growth of the enterprises.[1] However, they can also lead to distortionary effects, such as distortion to the international trade market, inefficient allocation of resources, reduction of efficiency in the market, etc.[2] Moreover, they have cross-border effects that can affect other countries' trade strategies. They further influence competition in the international market. Therefore, to control the detrimental effects of subsidies at a transnational level, countries have reached a common agreement to subject the use of subsidies to an international legal framework.

1.1.1 Subsidy rules of the WTO

The most influential international legal institution that disciplines subsidies is the World Trade Organization (WTO). The WTO deals with the rules of trade between nations. Its ultimate objectives are the creation of an open and non-discriminatory multilateral trading system by ensuring a level playing field for all the Members to conduct trade and international business.[3] The control of the adverse effects of subsidies worldwide is in line with the objectives of the WTO. In order to tackle the harmful effects of subsidies, the WTO provides specific rules, i.e. the

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[1] Alan O. Sykes, 'Subsidies and Countervailing Measures' in Patrick F.J. Macrory and others (ed), *The World Trade Organization : Legal, Economic and Political Analysis* vol 2 (The World Trade Organization : Legal, Economic and Political Analysis Springer 2005) 83-85; Claire Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* (Series on International Taxation, Volume 45, Wolters Kluwer, Law & Business 2014) 2-6.

[2] Ibid.

[3] Peter Van den Bossche, *The Law and Policy of the World Trade Organization : Text, Cases and Materials* (Cambridge University Press 2008) 85. The WTO's main activities are negotiating the reduction or elimination of obstacles to trade (import tariffs, other barriers to trade) and agreeing on rules governing the conduct of international trade (e.g. antidumping, subsidies, product standards, etc.); administering and monitoring the application of the WTO's agreed rules for trade in goods, trade in services, and trade-related intellectual property rights; settling disputes among members regarding the interpretation and application of the agreements, etc. See the WTO's official website, About the WTO <https://www.wto.org/english/thewto_e/whatis_e/wto_dg_stat_e.htm> accessed 11 February 2016.

Agreement on Subsidies and Countervailing Measures (the ASCM).[4] According to the ASCM, a subsidy is defined as a financial contribution made by a government or any public body, which confers a benefit that is specific.[5] In addition, the WTO has its own dispute settlement mechanism, the Dispute Settlement Body (DSB), which addresses disputes between nations. Members of the WTO receive recommendations from the DSB to adjust domestic subsidy measures, which are deemed as a means to regulate the adverse effects of those measures.

1.1.2 Tax incentives as subsidies

Tax incentives are one of the most employed subsidy types, due to their efficiency and flexibility. The concept of tax incentives is vague, but it has certain features. A common element in the notion is a deviation from a benchmark tax system.[6] In the context of international trade, tax incentives normally target economic development.[7] They can be considered as a transfer of government revenue that is achieved by reducing tax obligations based on a benchmark tax system.[8] Governments prefer to use this form of subsidy since it is more efficient and flexible. It does not require a direct grant of cash that could become a burden on fiscal expenditure. By using tax incentives, tax that would otherwise be due is foregone in the end.[9] Tax incentive subsidies also serve governments' policy goals, but they aim at specific objectives, such as attracting foreign direct investment (FDI) and promoting exports.

Similar to the rationale of regulating subsidies, it is also necessary to control the adverse effects of tax incentives. In the context of international trade, tax incentives have inbound and outbound effects. Inbound tax incentives are normally aimed at attracting FDI to a country's domestic market; outbound tax incentives are meant to stimulate a country's investment and enterprises to a foreign

[4] Agreement on Subsidies and Countervailing Measures (WTO), https://www.wto.org/english/docs_e/legal_e/24-scm.pdf.
[5] Article 1.1 of the ASCM.
[6] OECD, *Tax Expenditures in OECD Countries* (OECD 2010) 16.
[7] Yariv Brauner, 'The Future of Tax Incentives' in Yariv Brauner and Miranda Stewart (eds), *Tax, Law and Development* (Tax, Law and Development, Edward Elgar Publishing 2013) 25-26.
[8] Governments of developing countries especially tend to use tax incentives to attract foreign investment, particularly foreign direct investment (FDI). In such a context, tax incentives for FDI mean a special tax provision is granted to qualified investment projects that represent a statutorily favorable deviation from a corresponding provision applicable to investment projects in general. See Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 15; A. J. Easson, *Tax Incentives for Foreign Direct Investment* (Kluwer Law International 2004) 3.
[9] Carlo Pinto, *Tax Competition and EU Law* (Kluwer Law International 2003) 2-3.

or the international market, generally in the form of exportation.[10] Similar to the economic analysis of subsidies, the increasing adoption of tax incentives results in tax competition, i.e. the lowering of the tax burden in order to improve a country's economy and welfare by increasing the competitiveness of domestic business and/or attracting FDI.[11] It is also necessary to control the adverse effects of tax incentives, especially when they cause harmful tax competition. The adverse effects of tax incentives on tax competition are becoming a serious issue, since more and more countries start to seek transnational legal regulation. In 1998, the Organisation for Economic Co-operation and Development (OECD) published a report on harmful tax competition, which identified the characteristics of harmful tax competition.[12] More cooperation between countries at transnational level is going on.

1.1.3 EU State aid law

At the supranational level, the European Union (EU) also has a stringent internal subsidy control regime. State aid under the EU legal framework is a measure similar to the concept of a subsidy. The main object and purpose of the EU is the establishment of an internal market, which shall comprise an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured.[13] The concept of State aid is defined as any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.[14] It is obvious to see that this concept shares common elements with subsidies in the WTO's ASCM.

State aid law plays an increasing role in restricting the harmful effects of tax incentives in the internal market. In 1997, the European Commission adopted a code of conduct for business taxation (Code of Conduct) aiming at improving transparency in the tax area through the exchange

[10] OCED, *Subsidy Reform and Sustainable Development : Political Economy Aspects* (OECD 2007).
[11] Pinto, *Tax Competition and EU Law* 1-2.
[12] The report identified characteristics of harmful tax competition. They include no or low effective tax rates; ring-fencing, i.e. specific tax incentives for foreign taxpayers; lack of transparency; lack of effective exchange of information; artificial definition of the tax base; failure to adhere to generally accepted transfer pricing principles; exemption of foreign-source income; negotiable tax rate or tax base; secrecy provisions; treaty network; active promotion of tax scheme. See OECD, *Harmful Tax Competition, An Emerging Global Issue* (OECD 1998).
[13] Article 3 (3) of the Treaty on European Union (TEU) and Article 26 of the Treaty on the Functioning of the European Union (TFEU).
[14] Article 107 (1) TFEU.

of information.[15] Subsequently, in 1998, the Commission introduced a notice on the application of the State aid rules to measures relating to direct business taxation,[16] and a report on the implementation of the notice in 2004.[17] The European Commission has systematically applied State aid law to the regulation of tax incentives.[18] With the further development of State aid law under the State Aid Action Plan (SAAP)[19] and the programme on State aid modernization (SAM),[20] the application of State aid rules to taxation is evolving as well. In 2016, the European Commission issued a notice on the notion of State aid, which provides specific guidance on the identification of tax measures as State aid.[21] The trend in the EU is to strengthen the functionality of the State aid rules in relation to taxation.[22]

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[15] Code of Conduct, Council conclusions of the ECOFIN council meeting on 1 December 1997 concerning taxation policy [1998] OJ C2/1.

[16] Commission Notice on the application of the State aid rules to measures relating to direct business taxation [1998] OJ C384/3 (the 1998 Notice).

[17] Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation [2004] C (2004) 434.

[18] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 9.

[19] The SAAP is a plan from 2005 to 2009 aiming at improving the enforcement of State aid by introducing an effect-based approach to identify State aid. See State Aid Action Plan: Less and Better Targeted State Aid: a Roadmap for State Aid Reform 2005-2009 [2005] COM (2005) 107 final.

[20] In 2012, the European Commission set out a new reform programme on State aid modernization with more ambitious objectives, i.e. to foster growth in a strengthened, dynamic and competitive internal market; focus enforcement on cases with the biggest impact on the internal market; streamline rules and faster decisions. See EU State Aid Modernization (SAM), European Commission, Brussels, 8.5.2012, COM (2012) 209 final.

[21] On 19 May 2016, the European Commission published a Notice on the notion of State aid as referred to in Article 107 (1) TFEU. It explains how to identify tax rulings and tax settlements as State aid. See Section 5.4, Commission Notice on the Notion of State Aid as Referred to in Article 107 (1) TFEU [2016] OJ C262/1 (the 2016 Notice), see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016XC0719(05)&from=EN.

[22] EY Tax Insights, European Commission Publishes Guidelines Regarding State Aid <http://taxinsights.ey.com/archive/archive-news/european-commission-publishes-guidelines-regarding-state-aid.aspx> accessed 25 May 2016; European Commission-Press release, State Aid: Commission Concludes Belgian "Excess Profit" Tax Scheme Illegal; Around 700 Million Euros to be Recovered from 35 Multinational Companies (11 January 2016) <http://europa.eu/rapid/press-release_IP-16-42_en.htm> accessed 18 January 2016; European Commission-Press release, Commission Opens Formal Investigation into Luxembourg's Tax Treatment of McDonald's (3 December 2015) <http://europa.eu/rapid/press-release_IP-15-6221_en.htm> accessed 18 January 2016; European Commission-Press release, Commission Decides Selective Tax Advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU State Aid Rules (21 October 2015) <http://europa.eu/rapid/press-release_IP-15-5880_en.htm> accessed 18 January 2016; President Juncker, Commissioner Moscovici and Commissioner Vestager address the EP's Special Committee on Tax Rulings, 17 September 2015. See European Commission State Aid Weekly e-News, No. 30/15, 17/09/2015, <http://ec.europa.eu/competition/state_aid/newsletter/17092015.pdf> accessed 12 October 2015.

1.1.4 Chinese tax incentives and the WTO

China became a Member of the WTO in 2001. After its accession to the WTO, China was party to an increasing number of international trade disputes with other Members in the area of subsidies and countervailing measures. In the past ten years, China became the country facing the biggest number of countervailing investigations in the world.[23] Since 2004, when Canada launched the first countervailing investigation against China, more and more Members in the WTO had recourse to the subsidy rules to solve trade disputes with China.[24] Countervailing measures, a seldom-used method for solving international trade disputes, are becoming the main means for Members in the WTO to deal with trade disputes with China.

Among all the countervailing investigations against China, the main complaints were against Chinese tax incentives, such as specific tax reductions and exemptions, or specific tax preferences related to exports or imports.[25] The first case on Chinese tax incentives in the WTO was brought by the United States (US) in 2004 on China's preferential value-added tax (VAT) for domestically-produced or designed integrated circuits.[26] In 2007, the US requested a consultation in the WTO's DSB in another case on certain Chinese measures granting refunds, reductions or exemptions from taxes.[27] Subsequently, the EU also joined the group. In April 2010, the European Commission also claimed that Chinese tax incentives constituted subsidies under the ASCM in WTO law.[28] Therefore, China faces compatibility issues in relation to tax incentives in the WTO.

[23] By 31 December 2014, China had undergone 90 countervailing investigations: 46 were from the US, 20 were from Canada, 10 were from Australia, 9 were from the EU, 2 were from India, 1 was from Mexico, 1 was from South Africa, and 1 was from Egypt. See <http://www.wto.org/english/tratop_e/scm_e/scm_e.htm, Subsidies and Countervailing Measures Gateway, Statistics on subsidies and countervailing measures, countervailing initiations: reporting Member vs exporting country, 01/01/1995-31/12/2014> accessed 20 November 2015.

[24] Canada was the first country to initiate a countervailing investigation against China. The first investigation was launched on 13 April 2004 on the product of self-standing barbeques for outdoor use. It was a combined countervailing and anti-dumping investigation. For more information, see <www.cbsa.gc.ca> (Canada Border Service Agency): Anti-dumping and Countervailing-Investigations, accessed 20 November 2015.

[25] For a full list of subsidy investigations against China in the WTO, see Appendix I.

[26] WT/DS309/1, China-Value-Added Tax on Integrated Circuits, 23 March 2004, Panel Report.

[27] WT/DS358/1, China-Taxes, 7 February 2007.

[28] On 17 April 2010, the European Union also joined the trend to investigate Chinese subsidies on the product of coated fine paper. See Notice of Initiation of an Anti-subsidy Proceeding Concerning Imports of Coated Fine Paper Originating in the People's Republic of China [2010] OJ C99/13.

1.1.5 The evolution of Chinese tax incentives

Tax incentives in China have undergone an evolution. The People's Republic of China was established in 1949, but tax incentives were introduced only after 1978 when China initiated the Reform and Open Policy.[29] From 1978 to 2014, Chinese direct tax incentives experienced the "rise and fall" accompanied by the development of China's economy and its integration into the world economy. Beginning in 1978, China started a transition from a centrally planned economy to a market-oriented economy, aiming at integrating more into the world economy. In order to benefit from capital, advanced technology, and the international market, China decided to attract FDIs. As a result, the Chinese government granted direct tax incentives to foreign enterprises (FEs) and foreign invested enterprises (FIEs) located in Special Economic Zones (SEZs) and coastal cities. In addition to regional tax incentives, special FDI projects or activities received certain tax preferences as well, such as export-oriented and technologically-advanced projects.[30] The decades from 1980 to 2001 witnessed an expansion of direct tax incentives to FDIs in more industries and regions. Those direct tax incentives were deemed to be significant factors responsible for drawing FDIs that could stimulate the economy.[31] It was "the rise" of Chinese direct tax incentives. With China's accession to the WTO in 2001, the success of tax incentives for FIDs encountered challenges. As a Member of the WTO, China had to adjust its tax incentives in order to realize its promises of accession and obligations, i.e. to open its domestic market from the inbound perspective and to remove trade barriers, including subsidies from the outbound perspective. Subsequently, China began to change and clean up some tax incentives.[32] In 2007, the new Enterprise Income Tax Law (EIT Law) was promulgated[33] which terminated the situation that

[29] Before the Reform and Open Policy of 1978, China had experienced political campaigns and had few contacts with the world economy. The economic system was mainly a centrally planned economy. The role of taxation was diminished and simplified accordingly. See Pak K Auyeung, 'Taxation Trends and Issues in the People's Republic of China: 1949 to 2006' (2008) 62 Bulletin for International Taxation 248; Jinyan Li, *Taxation in the People's Republic of China* (Greenwood Publishing Group 1991) 14.

[30] Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 Florida Tax Review 675-676.

[31] Wanda Tseng and Harm Zebregs, *Foreign Direct Investment in China: Some Lessons for Other Countries* (Internat. Monetary Fund 2002); Samuel Tung and Stella Cho, 'The Impact of Tax Incentives on Foreign Direct Investment in China' (2000) 9 Journal of International Accounting, Auditing & Taxation 105-135.

[32] Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' 677-678; Chunlai Chen, *China's Integration with the Global Economy, WTO Accession, Foreign Direct Investment and International Trade* (Edward Elgar Publishing 2009) 29.

[33] Law of the People's Republic of China on Enterprise Income Tax, March 16, 2007. For the official English translation, see http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471133.htm.

foreign and foreign-invested enterprises enjoyed more preferential tax incentives than domestic Chinese enterprises. After this law, there was no longer an official tax incentive granting benefits only to foreign enterprises. Any enterprise satisfying certain conditions was eligible for the tax incentives stipulated in the law.[34] In 2013, the Chinese government decided to further the reform of the tax systems, with the emphasis on the governance of tax incentives. The aim was to promote equality in tax burdens and fair competition in the market.[35] The period from China's accession to the WTO until today could be characterized as the "fall" of Chinese direct tax incentives.

1.2 State of the art

Although WTO law does not specifically aim at regulating Members' tax policies, tax subsidy disputes indeed draw academic attention to the relationship between the two. Schön (2004) was among the first authors to study the connection between WTO law and tax law in general. He discussed the prohibitions on discrimination and protectionism on tax subsidies.[36] Lang and others (2005) published a book containing articles studying the relationship between WTO law and direct tax. It also includes different country reports reflecting the influence of WTO law on different countries' direct taxation.[37] Daily (2005) also wrote a discussion paper on the influence of the WTO's subsidy rules on the United States' tax policies based on the development of the Foreign Sales Corporation (FSC) cases brought by the European Communities.[38] These publications

[34] In order to ease the fear of foreign investors who previously enjoyed preferential tax treatment, the EIT law allowed existing FEs and FIEs to continue to enjoy the tax preferences until 2013 or until the specified period was over. See Article 57 of the EIT Law.

[35] See Section V of the Decision of the Central Committee of the CCP on Some Major Issues Concerning Comprehensively Deepening the Reform (the 2013 Decision). The 2013 Decision announced, "let the market decide the allocation of resources, the primary task is to build an open and unified market with orderly competition". For non-official English version of the 2013 Decision, see the English version of the 2013 Decision, *China Daily* (18 November 2013) <http://language.chinadaily.com.cn/news/2013-11/18/content_17112855.htm> accessed 10 March 2016.

[36] Wolfgang Schön, 'World Trade Organization Law and Tax Law' (2004) 58 Bulletin for International Fiscal Documentation 293.

[37] Michael Lang, Judith Herdin and Ines Hofbauer, *WTO and Direct Taxation* (Linde ; Kluwer Law International 2005).

[38] Michael Daly, *The WTO and Direct Taxation* (WTO Discussion Paper 2005). The first case in the WTO related to direct tax as subsidies was the Foreign Sales Corporation (FSC) Case, which was initiated by the European Communities (EC) in 1997 requesting consultations with the United States (US). FSCs were foreign corporations in charge of specific activities with respect to the sale or lease of goods produced in the US for export outside the US. The FSC legislation provided tax exemptions for foreign sales corporations in respect of their export-related foreign-source trade income. Thus, the US shareholders of the FSC were not subject to income tax on dividends received from the FSC. The EC contended that the special tax treatment for FSCs in the US constituted subsidies under the ASCM. For details, see

represent the interest of academics in the interaction between the WTO law and tax law. Nevertheless, they do not focus specifically on the WTO's subsidy rules and tax incentives *per se*. With respect to subsidies in the WTO, there are also a number of publications on the economic analysis of subsidies. Trebilcock (2012) and Jackson (2002) introduced the rationale for designing subsidy rules in the WTO in general. Skyes (2005) carried out a comprehensive economic analysis on subsidies, which became the context of understanding the ASCM. Taylor (2006) also analyzed the regulation of subsidies from the perspective of competition law. Krugman and Obstfeld (2009), Friederiszich and others (2008), and Feldman and Serrano (2006) conducted an economic analysis on subsidies from the perspective of international economics and welfare economics. However, these publications did not specifically focus on the analysis of tax incentives as subsidies.

More authors have discussed EU State aid and tax law since the EU paid attention to fiscal aid at an early stage. The application of State aid rules to taxation normally involves the identification of tax measures as State aid. Hancher, Ottervanger, and Slot (2012) addressed State aid comprehensively through the case law. This publication includes a chapter on applying State aid rules to taxation.[39] Rust and Micheau (2013) edited a book on State aid and tax law, which contains various articles discussing the application of State aid to taxation from diverse perspectives.[40] However, there is still space for further debate on State aid's regulation of tax incentives and on whether the State aid rules are appropriate to delve so deeply into tax issues.

As to the comparative studies between subsidies in the WTO and State aid in the EU, only some authors carried out the comparison systematically. Luja (2003) carried out a research on the relationship between direct tax incentives and EU State aid, which involved a certain comparison with the WTO's subsidy regime.[41] Luengo (2007) and Rubini (2011) conducted comparisons of

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WT/DS108/R, US-FSC, Panel Report, 8 October 1999; WT/DS108/AR/RW, US-FSC-Recourse to Article 21.5 of the Dispute Settlement Understanding (DSU) by the EC, Appellate Body Report, 14 January 2002; WT/DS108/AB/RW2, US-FSC, Second Recourse to Article 21.5 of the DSU by the EC, Appellate Body Report, 13 February 2006. C. Carmichael, 'Foreign Sales Corporations-Subsidies, Sanctions, and Trade Wars' (2002) 35 Vanderbilt Journal of Transnational Law 151; Hunter R. Clark, Amy Bogran and Hayley Hanson, 'The WTO Ruling on Foreign Sales Corporations : Costliest Battle Yet in An Escalating Trade War between the United States and the European Union?' (2001) 10 Minnesota Journal of Global Trade 291, 310.

[39] Leigh Ottervanger T. R. Slot P. J. Hancher, *EU State Aids* (Sweet & Maxwell 2012).

[40] Alexander Rust and Claire Micheau, *State Aid and Tax Law* (Kluwer Law International 2013).

[41] Raymond H.C.Luja, *Assessment and Recovery of Tax Incentives in the EC and the WTO: A View on State Aids, Trade Subsidies and Direct Taxation,* Antwerp: Intersentia, 2003.

the two systems in more detail respectively.[42] However, neither of these two publications carried out the research from the angle of taxation. In 2014, Micheau (2014) completed a comparative study of the WTO's subsidy regime and EU State aid law, focusing on tax incentives in general.[43]

With respect to Chinese tax incentives, there are a number of publications that discuss tax incentives for FDI before the implementation of the new EIT Law in China. For instance, Li (2007), Halkyard and Ren (2010) carried out historical reviews of Chinese corporate tax incentives for the attraction of FDI before the tax reform in 2007.[44] After the reform, some authors wrote about the system of tax incentives in general, such as Wang (2012) and Li (2012). However, after the reform, most favorable tax treatment for FDI was abolished. There are few publications discussing the relationship between current Chinese tax incentives and subsidy rules of the WTO, not to mention providing a comparative analysis from the perspective of EU State aid law. Therefore, for the first time this research systematically concentrates on current Chinese tax incentives and the WTO's subsidy rules, with a further reference to EU State aid law.

With respect to the background knowledge on Chinese law, history, and culture, there are many publications that address this in detail. Lubman (1999) and Peerenboom (2002) wrote about China's legal system in general but did not include the recent developments in the past decade. Cao (2009) studied Chinese tax law against the background of comparing China with the US. With regard to an introduction to Chinese history and culture, for instance, Cambridge University (1986-1991) published a series of books on Chinese history in different stages before the Reform and Opening. Goldin (2011) and Littlejon (2011) introduced Confucianism in China. All of these publications contribute to understanding the context surrounding Chinese tax incentives.

In contrast, a number of publications on Western history and culture help to understand the context of the development of the WTO and the EU. For example, Cambridge University also published a series on the history of Capitalism (2014), which provides a basis to understand the

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[42] Gustavo E. Luengo, *Regulation of Subsidies and State Aids in the WTO and EC Law, Conflicts in International Trade Law*, Alphen aan den Rijn: Kluwer Law International, 2007; Luca Rubini, *the Definition of Subsidy and State Aid, WTO and EC Law in Comparative Perspective*, Oxford: Oxford University Press, 2011.

[43] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law*.

[44] Jinyan Li, *the Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, Florida Tax Review, Volume 8, No.7, 2007; Andrew Halkyard, Ren Linghui, *China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis*, in Arthur Cockfield (Eds.), *Globalization and Its Tax Discontents: Tax Policies and International Investments: Essays in Honour of Alex Easson*, 2010.

development of international trade and the development of the market economy. Weber (2002) explained the spirit of capitalism that also helps to understand the context of Western culture. They form basis from which the background of the WTO and the EU with its counterpart in China can be compared.

1.3 Research questions and methodology

1.3.1 Main research questions

The main research questions are:

What is and what should China's position be towards tax incentives in the international trade domain based on comparative studies between the subsidy rules of the WTO and EU State aid law?

What should the WTO's position be towards China and taxation with respect to subsidy rules based on the studies on Chinese tax incentives and EU State aid law respectively?

In order to answer the main research questions, firstly, it is necessary to analyze the relationship between Chinese tax incentives and the WTO's subsidy rules, especially with reference to EU State aid law. After finding out the extent of the compatibility of Chinese tax incentives with the two legal systems, it is easier to see whether there are tensions between Chinese tax incentives and both standards. Subsequently, if there are tensions, after analyzing the origins of those tensions, the research eventually answers the main research questions by providing recommendations for Chinese tax incentives to find a proper position in the international trade domain. On the other hand, the research also sheds light on the role of the WTO in relation to the regulation of taxation and subsidy rules *per se* by learning from its interactions with China and EU State aid respectively.

However, it has to be emphasized that the first research question is the core of the research, while the second research question is a further thinking based on the first one. The concentration of the research is still Chinese tax incentives, not the WTO law. Recommendations for the WTO are logical results of the whole analysis, which sufficiently answer the second research question. The second research question actually could be a starting point for a new research with regard to how to improve WTO law *per se* so that it can integrate more on an international level. It has so many different Members with different economic, political, and cultural background, so there could be a new research on the WTO's system itself on developing rules that can apply to countries that share common characteristics with China. Nevertheless, this research concentrates on the

relationship between Chinese tax incentives and WTO's subsidy rules against the background of EU State aid, so answers to the second research question are not that in depth with regard to the WTO law.

1.3.2 Sub-questions

The sub-questions are:

In the context of international trade and competition, what are tax incentives as subsidies? What is the rationale for regulating tax incentives as subsidies?

What are the subsidy rules of the WTO and EU State aid law with regard to taxation respectively? Can a common benchmark be derived from the two systems that would serve for the evaluation of Chinese tax incentives against the rules of the two systems *per se*?

What is the situation of Chinese tax incentives? Is there a domestic benchmark in China to evaluate the granting of tax incentives? If so, what is the relationship between the internal benchmark and the external benchmark derived from the WTO and EU?

Are selected Chinese tax incentives compatible with the WTO's subsidy rules? Under the EU State aid regime, are there differences in the results?

What are the origins of the tensions between Chinese tax incentives and the Western approach to tax incentives? Is it possible to alleviate the tensions?

What is the future for Chinese tax incentives with respect to the WTO's subsidy rules and against the background of EU State aid? What is the role of the WTO's subsidy rules in relation to the regulation of taxation and subsidy rules *per se* by learning from its interactions with China and EU State aid respectively?

1.3.3 Methodology

The major methodologies adopted in the research are legal analysis, comparative studies, legal testing, and historical analysis.

To analyze the relationship between Chinese tax incentives, the WTO's subsidy rules, and EU State aid law, the research tests selected Chinese tax incentives against the WTO's subsidy rules and the EU State aid law respectively.

Firstly, the research provides a general overview of tax incentives as subsidies based on the theory of public finance and welfare economics, including reasons for the government to grant subsidies, their effects, and the rationale behind regulating the abuse of subsidies in the context of international trade and competition. Subsequently, the research describes subsidy rules in the WTO and EU State aid law, especially their application to taxation, and makes a comparison between the two. Based on the common object and purpose of the two systems, an external benchmark is developed to guide the further testing. Additionally, an internal domestic benchmark in China is also developed according to China's domestic market conditions. It serves as a foundation for applying the international standard to Chinese tax incentives. Moreover, it exhibits differences between the Western originated benchmark and the Chinese counterpart. Considering the broad scope of tax incentives in China, the research selects specific tax incentives to complete the testing. It includes both direct tax and indirect tax that are related to business investment and international trade. Afterwards, those Chinese tax incentives selected are tested against the subsidy rules of the WTO and EU State aid law respectively to check their compatibility and to present differences in the testing results. These tax incentives are also under evaluation according to the benchmarks. Furthermore, the research examines whether there are tensions in the testing results and analyzes the origins of the tensions from an historical, economic, and cultural perspective. Consequently, the research provides legal recommendations for Chinese tax incentives to align with international trade rules. Further, it sheds light on the future of the WTO's subsidy rules and their role in taxation, which is inspired by China's influence and EU State aid law.

1.4 Limitations

In order to confine the scope of the discussion to answering the research questions, there are major limitations of the research.

First of all, the boundary of the research is business taxation in the context of international trade and investment. WTO law covers diverse areas in international trade, which includes the separate regulation of agricultural products, the Regulation of Subsidies in the Agreement on Agriculture (AOA).[45] This research concentrates on business investment in international trade. On the one

[45] The AOA allows for domestic support to agricultural products but with annual limits for each Member in the specific Schedules of Commitments. See Gustavo E. Luengo Hernández de Madrid, *Regulation of Subsidies and State Aids in WTO and EC law : Conflicts in International Trade Law* (Kluwer Law International 2007) 207-243.

hand, most trade disputes on subsidies between China and other Members of the WTO are directly related to Chinese domestic market access for foreign investment or China's exportation to foreign countries.[46] On the other hand, in general, the target of most tax incentives is business investment, either for the attraction of FDIs or for the promotion of domestic investment abroad.[47] Therefore, this research only focuses on business taxation that influences international trade. Tax incentives for agriculture, fisheries, and other non-business activities are not discussed in this research.

Secondly, WTO law comprises a range of subsidy rules and case law, but the research focuses on the regulation on subsidies through the ASCM. The research conducts testing of selected Chinese tax incentives against the WTO's subsidy rules, and therefore it requires relatively concrete rules and the definition of a subsidy to proceed with the testing. The ASCM is the outcome of previous negotiations in different phases of the development of WTO law.[48] The most important feature of the ASCM is that it has an internationally agreed upon definition of the term subsidy and criteria on the classification of subsidies. Therefore, it provides a relatively clear reference to carry out the testing. Furthermore, the ASCM only aims at regulating subsidies on goods, but it does not cover subsidies on services.[49] The major trade disputes between China and other WTO Members are on goods but not on services until now.[50] Thus, the research focuses on subsidies on goods. Furthermore, the research does not refer to subsidy rules on agricultural products, i.e. the AOA.

With regard to the term tax incentive, the research does not provide a comprehensive definition, but it recognizes its characteristics in order to clarify the use of the terminology. A major characteristic of a tax incentive is a deviation from the general benchmark of taxation.[51] It is a

[46] See Appendix I: Matrix of subsidy investigations towards China in the WTO.
[47] Easson, *Tax Incentives for Foreign Direct Investment*; John Chown, 'Tax Competition' (2003) Tax Reform and Simplification 4.
[48] The development of subsidy rules in the WTO has been subject to negotiations in the period of the adoption of the General Agreement on Tariffs and Trade (GATT) 1947, the 1979 GATT Subsidies Code in the Tokyo Round, and the ASCM in the Uruguay Round. For a detailed description, see Section 3.2.2 in Chapter 3.
[49] Although there are discussions on referring to services in the definition of subsidy in the ASCM, there is no substantial progress in relation to this in the WTO's negotiations. See Rüdiger Wolfrum and Peter-Tobias Stoll, *WTO : Trade Remedies* (Max Planck Institute for Comparative Public Law and International Law 2008) 352.
[50] See Appendix I: Matrix of subsidy investigations towards China in the WTO.
[51] Easson, *Tax Incentives for Foreign Direct Investment* 3; Wolfgang Schön, *Tax Competition in Europe* (IBFD Publications 2003) 14.

transfer of government revenue by decreasing tax obligations based on a reference tax system.[52] In the context of this research, it concentrates on tax incentives as subsidies. If a tax incentive applies to all, it is general, whereas if it is only limited to selected subjects or regions, it can be regarded as specific. Subsidy regulations in both the WTO and the EU State aid regimes target specific governmental measures. Thus, there is a distinction between general tax incentives and specific tax incentives. In this research, the term tax incentive mainly refers to specific tax incentives as subsidies.

In addition, the research does not conduct a systematic comparison between the subsidy rules of the WTO and EU State aid law, and therefore it does not follow the typical methodologies in comparative law.[53] The comparative study in this research aims at uncovering differences between the results of the separate testing. Thus, the focus is on the application of the rules of the two legal regimes to Chinese tax incentives. EU State aid law shares common objectives and has a similar legal design as the WTO's subsidy rules. Therefore, the main purpose of the comparative testing is to see whether EU State aid law can be a source of inspiration for both the WTO and China.

Moreover, the scope of Chinese tax incentives is limited to the present tax incentives, including both direct and indirect tax incentives. The evolution of tax incentives in China reveals that, in the area of corporate taxation, most preferential tax incentives for FDIs were abolished after the promulgation of the EIT law. Because the context of the research is business taxation of international trade and investment, the research focuses on corporate tax incentives after the promulgation of the EIT law. With regard to indirect tax, the research is limited to current value-added tax (VAT) incentives that are related to imports and exports. The whole VAT system is still under reform in China and most previous consumption tax will be transferred into the VAT system.[54] Thus, the research focuses on VAT incentives that have already experienced the reform.

With regard to the source of tax incentives, the research selects tax incentives only from official laws, regulations, and circulars issued by the legislative authorities. The EIT law has a separate

[52] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 15.
[53] For typical methodologies in comparative law, see Konrad Zweigert, Hein Kötz and Tony Weir, *Introduction to Comparative Law* (3rd rev. ed. edn, Clarendon Press 1998); Maurice Adams, Dirk Heirbaut and Mark Van Hoecke, *The Method and Culture of Comparative Law : Essays in Honour of Mark Van Hoecke* (Hart Publishing 2014).
[54] For a further introduction on VAT, see Section 4.7 in Chapter 4.

section on tax incentives which serves as a basis for the selection of corporate tax incentives. Moreover, the tax authorities in China are the State Administration of Taxation (SAT) and the Ministry of Finance (MoF). They are endowed with legislative power to issue specific tax incentives. These official regulations or circulars are also considered tax laws in China.[55] The research only addresses tax incentives from these official tax laws and selects tax incentives from the SAT's official databases.[56] Therefore, it only analyzes official tax incentives granted by the tax authorities at the central government level, but it does not examine local tax incentives that are discretionarily granted by local governments. The major reason is that the central government is working on cleaning up illegal local tax incentives granted by local governments.[57] As a result, most local tax incentives are probably going to disappear. They are not reliable in this research to perform the testing and further analysis.

Another issue concerning the selection of tax incentives is specificity. The research only selects tax incentives that are specific to certain enterprises or regions, since specificity is an essential standard in both the WTO's subsidy regime and the EU State aid regime to qualify as a subsidy and a State aid. If a tax incentive is applicable to everyone, it is not likely to constitute a subsidy or a State aid, and therefore it probably will not become a problem. The research therefore analyzes specific tax incentives that are likely to be incompatible with the international criteria.

When discussing the origins of tensions between China and the WTO and EU State aid law, respectively, the research uses the term "the West" to distinguish from China. The research presents China as having its own path towards the granting of tax incentives compared to the major Members of the WTO. Therefore, in order to demonstrate the differences between China and the WTO and the EU system, the research uses the term "the West", which generally represents the context of the WTO and the EU. The distinction between China and the West is to present that the starting points of Chinese tax incentives differ from the Western counterpart. Therefore, the

[55] Wei Cui, 'What is the'Law'in Chinese Tax Administration?' (2011) 19 Asia Pacific Law Review
[56] The SAT notice [2015] No.73, Notice on the Issuing of the Code Directory of Tax Incentives, by the SAT, 29 October 2015; the SAT notice [2015] No.76, Notice on the Issuing of Administrative Regulation of Corporate Tax Incentives, by the SAT, 12 November 2015.
[57] The Chinese State Council issued an official document with the purpose of establishing an open and competitive market system, which emphasized removing local discretionary tax incentives. See Guofa [2014] No.62, Notice on the Clearance of Tax and Other Incentives, by the State Council, 27 November 2014.

research does not discuss other transitional economies in the EU or the WTO that share similar characteristics with China.

Lastly, the sources of the research, including literature, legislation, cases, news are updated until July 2016.

1.5 Relevance of the research

This research can inspire China on reviewing its attitude toward tax incentives, can benefit the WTO for rethinking its subsidy rules, and can shed light on the EU State aid law as well. To be specific, it provides insights to the alleviation of tensions between Chinese tax incentives and the WTO's subsidy rules, thus further offering implications for both China and the WTO on integrating in the world economy. Moreover, doing a comparative study with EU State aid law can also provide China with a source of inspiration for reviewing its legal mechanism in respect of tax incentives and the WTO for rethinking its subsidy rules with regard to achieving its objectives and purposes.

First of all, this research can contribute to the settlement of trade disputes between China and other WTO Members. The understanding of the relationship between a number of the current Chinese tax incentives and the WTO's subsidy rules identifies whether these Chinese tax incentives can constitute subsidies under the WTO rules. As stated in the research background, China suffers most countervailing investigations from other Members of the WTO, especially with focus on tax incentives.[58] The research analyzes the compatibility of some of the most recent Chinese tax incentives against the WTO's subsidy rules. Thus, it sheds light on the settlement of trade disputes between China and other Members.

Moreover, the research provides insights into the further integration of China into the world economy. In past decades, China's economy was boosting, especially after its accession to the WTO.[59] It was not only considered as the "factory of the world" but also as the "market of the world" because of the increasing purchasing power of Chinese people.[60] As a significant emerging

[58] See Appendix I of the research; Han Xiuli and Gao Bo, 'Export Taxes under the WTO System: Chinas Way Out of the Dilemma' (2013) 10 Manchester Journal of International Economic Law 336.
[59] China's gross domestic product (GDP) ranks 2nd in the world in 2015. See the World Bank data, <http://data.worldbank.org/data-catalog/GDP-ranking-table> accessed 4 December 2015.
[60] Interview with Deputy Commissioner Zhang Zhiyong, Strengthening Global Tax Cooperation and Combating International Tax Avoidance and Tax Evasion (8 December 2014),

power in the world economy, the role of tax incentives in China is changing. If there are deeper tensions between Chinese tax incentives and the WTO's subsidy rules, it is important to analyze what the causes of these tensions are, because they will provide insights in how China can find solutions to alleviate them. By exploring China's attitude towards those tax incentives and the rationale behind granting them, it is easier to make suggestions adjusting those controversial tax incentives if China aims to further integrate into the world economy. Taking into account the world standard when designing tax incentives will help China further to create a fair market that is familiar with and attractive for more international investment. As a result, such an approach will not only benefit China's economic growth, but it will also create a better investment environment for foreign investors.

This research can also inspire the WTO to rethink its subsidy rules and its role in respect of taxation. In case of tensions between Chinese tax incentives and the WTO's subsidy rules, it is a good opportunity for the WTO to review its rules, especially if its rules cannot function well to realize its objects and purposes. The alleviation of tensions not only requires China's adjustment of tax incentives, but also requires the WTO to improve its rules. China is a young Member of the WTO, which has a quite different economic system compared to many other Members. With the increase of the number of Members of the WTO, the original rules should be adjusted accordingly in order to integrate further with an increasing number of national economies of a different nature.

Additionally, similarities exist between the WTO's subsidy rules and EU State aid law. The two regimes share a common objective: in order to guarantee a well-functioning international respectively internal market, it is necessary to regulate interventions of governments in the market. The common objective of creating a level playing field guides the design and functionality of the two regimes in a similar way. However, even though they share common objectives, the two systems are different, especially concerning tax matters. Actually, the two systems show distinct developments in how they apply to taxation. Therefore, doing a comparative study from the EU State aid perspective will provide an insightful and innovative angle to reflect on the relationship between the world's general trade standard in respect of the regulation of subsidies and China's attitude towards tax incentives. The EU is one of the most integrated regional economic areas of

<http://www.chinatax.gov.cn/n810219/n810724/c1353155/content.html> (in Chinese) accessed 4 December 2015.

all regional economic areas. The internal market of the EU is closest to a domestic market. In the context of creating a level playing field in the internal market, the EU State aid rules play an essential role. Therefore, the EU State aid regime is most suitable for a comparative study. Indeed, EU State aid law is not a perfect system taking into account i.e. the current debate on strengthening the regulation in respect of tax competition.[61] However, EU State aid law, in particular the case law in this context, will provide a rich source for comparison since its body has strongly developed over a number of decades. Considering its success of influencing the development of the EU by creating fair competition in the internal market, it can serve very well as a source of inspiration for China and the WTO. Therefore, the comparative study may not only inspire China to review the granting and regulation of tax incentives, but it may also shed light on the need for the WTO to rethink its subsidy rules and its position towards taxation.

1.6 Structure of the research

The structure of the research is developed according to the main research questions and sub-questions, in accordance with the methodologies and limitations.

Chapter 1 introduces the background of the research, research questions, methodologies, and limitations.

Chapter 2 provides an overview on subsidies and tax incentives as subsidies in the context of international trade and investment. It analyzes the rationale of granting tax incentives as subsidies by governments and the corresponding effects of tax incentives as subsidies, especially the harmful effects. It also discusses reasons for the international legal regulation on tax incentives as subsidies.

Chapter 3 introduces the subsidy rules of the WTO and EU State aid law respectively, with the focus on their application to taxation. Based on the common object and purpose of the two systems, the chapter first establishes an external benchmark to evaluate the following testing. Furthermore, by comparing the two legal systems, the chapter presents the major similarities and differences between them.

[61] Rens Bondrager and others, 'The Impact of Fiscal State Aid Recovery Risks on Share Purchase Agreements' (2016) 56 European Taxation ; Jean Schaffner and Sophie Balliet, 'BEPS, EU State Aid Investigations and LuxLeaks: And What about Luxembourg?' (2016) 23 Internatinal Transfer Pricing Journal ; Anja Taferner and Jurjan Wouda Kuipers, 'Tax Rulings: In Line with OECD Transfer Pricing Guidelines, but Contrary to EU State Aid Rules?' (2016) 56 European Taxation

Chapter 4 introduces Chinese tax incentives. It includes two parts: the first part is a chronological review of the evolution of direct tax incentives in China. It introduces the "rise and fall" of tax incentives for FDI in China. The chapter then develops an internal benchmark for the evaluation of Chinese tax incentives. The second part is an introduction to current Chinese tax incentives, including corporate tax incentives and VAT incentives.

Chapter 5 is the testing part in which selected Chinese tax incentives are tested against the WTO's subsidy rules and EU State aid comparatively. The testing follows the steps synthesized in Chapter 3. This chapter also adopts the external and internal benchmarks to review the comparable testing. Consequently, it not only reveals the compatibility of certain Chinese tax incentives with the WTO's subsidy rules, but it also displays differences in the testing results.

Chapter 6 analyzes tensions between Chinese tax incentives and the Western treatment of tax incentives, which are revealed by the testing results. It further provides a rethinking of the origins of the tensions from both the Western and China's perspective. It shows different paths that China and the West have taken historically, economically, and culturally. Nevertheless, it also presents possibilities to alleviate tensions between Chinese tax incentives and the Western standard.

Chapter 7 answers the research questions by providing recommendations for Chinese tax incentives and future of the WTO's subsidy rules, especially by referring to EU State aid law. On the one hand, it provides legal recommendations for China towards the granting of tax incentives considering its position in international trade and investment. On the other hand, considering EU State aid law and China's influence, it presents the potential developments for the WTO's subsidy rules and its role in taxation.

Chapter 8 summarizes the results of the research and presents recommendations.

Chapter 2 Overview of Tax Incentives as Subsidies in the Context of International Trade and Competition: Rationale for Granting and Regulating Tax Incentives

2.1 Introduction

In the context of international trade and competition, the use of subsidies is becoming an increasingly important issue. Tax incentives are among the most popular type of subsidy that governments use to grant financial aid. By using this method, tax that otherwise would be due is foregone in the end.

This chapter starts with the basic economic theories on market, trade, and competition. Afterwards, it defines subsidies and tax incentives as subsidies. Subsequently, according to the benchmarks of efficiency and equity, it analyzes how tax incentives as subsidies work in the international trade context and their effects for each participant in the market. Based on the effects, the chapter analyzes the rationale behind using tax incentives from a government's perspective and, more importantly, the rationale behind regulating them. Moreover, it emphasizes the legal regulation of the harmful effects of tax incentives and the necessity for international regulation.

The context of this research is international trade and competition, which limits the analysis of the effects of tax incentives to the basic theories on economics and public finance. They are also the starting points to gain an understanding of the rationale for granting and regulating tax incentives.

2.2 Overview of subsidies

With the development of globalization and the increasing international competition in relation to resources, subsidies are becoming a frequently used measure to sponsor certain economic activities in the form of governmental financial and fiscal assistance. Especially after the Second World War, governments have used more and more subsidies to reach social, economic, and political goals.[62]

[62] Dominic. Coppens, *WTO Disciplines on Subsidies and Countervailing Measures* (Cambridge University Press 2014) 5.

2.2.1 Premise

2.2.1.1 Market, trade, and competition[63]

Before discussing the concept, effects of subsidies, and the rationale for disciplining subsidies, it is necessary to clarify certain terms and the context of the discussion. The starting point is to understand market, trade, competition, and the relationship between them.[64]

2.2.1.1.1 The market system

Currently international trade refers to the circulation of productive factors, goods and services in domestic or international markets.[65] The background to international trade is the existence of a market.[66] As explained by economists, the market allocates scarce resources between competing end users. In a market, there are two major actors: producers and consumers. A market system actually describes the actual and potential transactions and decisions about production and consumption between producers and consumers.[67] In an international market, producers and consumers from different countries compete with each other through trade. Competition means the extent of the actual and potential rivalry between producers for the support of consumers within

[63] The economic analysis of subsidies can be viewed from both the trade perspective and the competition or welfare perspective. Therefore, subsidies are the subject of international trade law and international competition law. See Luca Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective* (Oxford University Press 2009) 25-26; Martyn D. Taylor, *International Competition Law : A New Dimension for the WTO?* (Cambridge University Press 2006) 163-184.

[64] To introduce the basic theories on market, trade, and competition, I have referred to some sources. See for instance, Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective*; Taylor, *International Competition Law : A New Dimension for the WTO?*; Michael Trebilcock, Robert Howse and Antonia Eliason, *The Regulation of International Trade* (Taylor and Francis 2012); John H. Jackson, *The World Trading System : Law and Policy of International Economic Relations* (2nd ed., 5th print. edn, MIT Press 2002); Kyle W. Bagwell, George A. Bermann and Petros C. Mavroidis, *Law and Economics of Contingent Protection in International Trade* (Cambridge University Pres 2014); Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law*; Alan O. Skyes, *Subsidies and Countervailing Measures* (Springer 2005); Richard Whish and David Bailey, *Competition Law* (7th [rev. and updated] ed. edn, Oxford University Press 2012); Allan M. Feldman and Roberto Serrano, *Welfare Economics and Social Choice Theory* (Springer 2006); Hans W. Friederiszick, Lars-Hendrik Röller and Vincent Verouden, 'European State Aid Control : An Economic Framework' in Paolo Buccirossi (ed), *Handbook of Antitrust Economics* (Handbook of Antitrust Economics, MIT Press 2008); Damien Neven and Vincent Verouden, 'Towards a More Refined Economic Approach in State Aid Control' in Wolfgang Mederer and Brice Allibert (eds), *EU Competition Law* vol IV (EU Competition Law Claeys & Casteels 2008); Paul Krugman and Maurice Obstfeld, *International Economics : Theory & Policy* (The Addison-Wesley Series in Economics, 8th ed. edn, Pearson/Addison-Wesley 2009); Dennis R. Appleyard, Alfred J. Field and Steven L. Cobb, *International Economics* (7th ed. / edn, McGraw-Hill 2009).

[65] Jackson, *The World Trading System : Law and Policy of International Economic Relations* 11-13.

[66] Ibid; Skyes, *Subsidies and Countervailing Measures* 85-86; Taylor, *International Competition Law : A New Dimension for the WTO?* 8; Whish and Bailey, *Competition Law* 3-4.

[67] Taylor, *International Competition Law : A New Dimension for the WTO?* 9-15.

this market in price and non-price terms.[68] The relationship between market, trade, and competition can be generalized as "competition occurs through trade in a market."[69]

The standard for evaluating the functioning of the market is economic efficiency, which refers to the optimal use and allocation of resources by the market.[70] Based on the theory of welfare economics, the ultimate objective of a well-functioning market is to maximize social welfare.[71] Social welfare consists of two basic elements: efficiency and equity.[72] Efficiency means pushing the welfare frontier outward, i.e. "making the cake bigger", but equity requires moving along the welfare frontier, i.e. "dividing the cake better".[73]

(1) Efficiency considerations

From the perspective of efficiency, social welfare represents the measurement of the welfare gains arising from market transactions, which is the aggregate of the net welfare benefit accruing to both producers and consumers from the market transactions.[74] Under perfect competition,[75] an optimal operation of the market leads to greater economic efficiency, thereby maximizing social welfare. Furthermore, competition enhances efficiency in the market. For producers, competition will stimulate them to minimize the costs of production and to explore new products as well, which can result in production efficiency and dynamic efficiency. For consumers, the outcome of

[68] Ibid 11.
[69] Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective* 25.
[70] According to the modern neoclassical microeconomic theory, the standard economic efficiency is "Pareto efficiency", which means a reallocation of resources that would increase the welfare of at least one person without decreasing the welfare of anyone else. Economists further develop the concept as a "Kaldor-Hicks efficiency improvement". This means that an optimal market leads to three types of economic efficiency: production efficiency (products, including goods or services, are produced at the lowest cost), allocative efficiency (allocating available resources of production to work where they contribute most to the welfare), and dynamic efficiency (producers have the incentives to search for new products). See Whish and Bailey, *Competition Law* 4-6.
[71] Welfare economics is a normative branch of microeconomic theory concerned with the manner in which economic activity ought to be arranged to maximize economic welfare. See Taylor, *International Competition Law : A New Dimension for the WTO?* 11.
[72] Feldman and Serrano, *Welfare Economics and Social Choice Theory* 1-10.
[73] Friederiszick, Röller and Verouden, 'European State Aid Control : An Economic Framework' 640-643.
[74] Whish and Bailey, *Competition Law* 4.
[75] The conditions of perfect competition are assumptions for this conclusion. They include utility maximization by consumers; stable preferences; rational profit maximization by producers; stable technologies; perfect information; costless transactions; perfect competition; homogeneous products; no barriers to entry; a complete set of markets; and producers are price takers. See Taylor, *International Competition Law : A New Dimension for the WTO?* 14.

competition between producers are better products or services, lower prices, and broad choices, which embody allocative efficiency.[76]

However, in reality, perfect competition in the market is rather rare, whereas imperfect competition is the normal status. When the resources cannot be allocated appropriately by the market, market failures appear.[77] There are several reasons for market failures, such as imperfect competition, public goods, externalities, incomplete markets, imperfect information, unemployment, and other macroeconomic disturbances.[78] The main market failures that may be relevant in the context of subsidies are externalities[79] and imperfect information.[80] Therefore, economists suggest that government intervention in the market has the potential to offset market imperfections and to allocate resources to achieve optimal results.[81] They developed the Theory of Second Best to depict the effects and risks of government intervention.[82] It reveals that governmental intervention aimed at correcting market imperfections in one market may cause

[76] Coppens, *WTO Disciplines on Subsidies and Countervailing Measures* 6-8.
[77] John O. Ledyard, 'Market Failure' in Steven N. Durlauf and Lawrence E. Blume (eds), *The New Palgrave Dictionary of Economics* (The New Palgrave Dictionary of Economics, Palgrave Macmillan 2008).
[78] R. H. Coase, 'The Problem of Social Cost' (1960) 3 The journal of law & economics 1. In addition, the theory of economic efficiency assumes that all businessmen are rational and always attempt to maximize profits. However, in the real world, this is not necessarily the case. See Whish and Bailey, *Competition Law* 8-9.
[79] Externalities arise when actions by one agent have consequences for other agents. The effects can be negative or positive and, when these effects are not taken into account thoroughly, they will result in imbalances between the private benefits of a given action and the overall benefits of the action, which can cause market failures. See Jean-Jacques Laffont, 'Externalities' in Steven N. Durlauf and Lawrence E. Blume (eds), *The New Palgrave Dictionary of Economics* (The New Palgrave Dictionary of Economics, Palgrave Macmillan 2008).
[80] For instance, information asymmetry. This means that one competitor has access to better information than other competitors in the market. Therefore, the competitor with the better information has more capacity to perform well in the market, thus gaining more advantages. See Neven and Verouden, 'Towards a More Refined Economic Approach in State Aid Control' 9.
[81] The relationship between the market and the government is a dynamic process. Free market theory can be dated back to Adam Smith, in the 18th century, who advocated free competition in the market and objected to any form of governmental regulation. With the development of the economy, more economists developed further theories on this issue. Keynes is renowned for advocating for governmental intervention in the market in the time of the Great Depression after the Second World War. Chapter 6 further addresses this issue.
[82] R. G. Lipsey and Kelvin Lancaster, 'The General Theory of Second Best' (1956) 24 The Review of Economic Studies 11, 11-24.

market imperfections in other markets. Thus, governments should only intervene when they can accurately identify and address the market imperfections.[83]

(2) Equity considerations

Another concern arises from the perspective of equity. The economic theory on efficiency proves that competition enhances efficiency in the market. Thus, it is necessary to create a level playing field for competition.[84] However, the concept of equity is not only an economic term, but it also contains legal, social, and cultural values, which make it more subjective and distinctive internationally.[85] In the context of the current discussion on market, trade, and competition, it also refers to the redistribution of social welfare to achieve social equity. As advocated by Rawls (1999), distributional fairness is a way to realize justice.[86] Following the logic of creating fair competition in the market, the starting point here is the equity between producers, i.e. equal opportunities for all the producers in the market. The market mechanism itself actually distributes welfare between producers and consumers, since competition improves the allocative efficiency of producers. As a result, it ensures that producers do not get all the gains of productive efficiency, but it also transfers such gains to consumers via reduced prices.[87] However, as analyzed earlier, the market has imperfections meaning that it does not always distribute welfare to the optimal extent. Intervention by the government therefore has the objective of achieving distributional equity between producers and consumers. The ultimate goal is to distribute welfare among society more fairly, i.e. "dividing the cake better". To summarize, the creation of a level playing field for competition aims to achieve efficiency in the market as a starting point. The objective can be to realize distributional equity for all the participants in the market with respect to social welfare. Nevertheless, there are always

[83] Government intervention is regarded as the second best action to address market imperfections. The best solution is to remove market imperfections by the market mechanism itself. See Taylor, *International Competition Law : A New Dimension for the WTO?* 14-15.
[84] Friederiszick, Röller and Verouden, 'European State Aid Control : An Economic Framework' 640.
[85] "Different nations emphasize different aspects of fairness in accordance with their different social values, norms, customs and collective preferences." See Taylor, *International Competition Law : A New Dimension for the WTO?* 26-27.
[86] There are two basic principles of fairness. First, everyone will have an equal right to the most extensive basic liberties compatible with similar liberty for others; second, social and economic inequalities must satisfy two conditions: they are to the greatest benefit of the least advantaged and they are attached to positions open to all under conditions of fair equality of opportunity. See John Rawls, *A Theory of Justice* (Belknap Press of Harvard University Press 1999).
[87] Taylor, *International Competition Law : A New Dimension for the WTO?* 26.

trade-offs between efficiency and equity depending on different governments' social and economic objectives.[88]

In summary, the relationship between market, trade, and competition serves as the foundation to further understand subsidies. The premise for the discussion of subsidies is the existence of the market system, liberalized trade, and competition in the market.[89] Moreover, market, trade, and competition are dynamic processes. This means that the economic analysis of subsidies is not static.

2.2.1.2 The theory of comparative advantage

The theory of comparative advantage, promoted by David Ricardo (1871), explains the reasoning for the existence of international trade.[90] The theory maintains that each country has an absolute advantage with respect to one of the products, i.e. each country can produce greater quantities of one product more cheaply than the other country, and that trade between these two countries improves their economic situation. If one country has an absolute advantage with respect to one product and the other country has an absolute advantage with respect to another product, the exchange between both countries will be advantageous if the relationship between the internal costs of producing the two products is different. [91]

Further, Heckscher and Ohlin developed the theory to include factors of production in 1920s (the Heckscher-Ohiln Theorem), which emphasized that international trade arises due to differences in each country's resources. [92] In the Ricardian theory, costs of production are exogenously determined by the available technology. Countries specialized in the production of those goods can produce with the lowest cost. On the contrary, the Heckscher-Ohlin Theorem

[88] For instance, American competition law emphasizes efficiency in the market more, whereas EU competition law puts more emphasis on distributional equity. See Louis Kaplow and Steven Shavell, *Fairness versus Welfare* (Harvard University Press 2002).
[89] Trebilcock, Howse and Eliason, *The Regulation of International Trade* 15-17; Jackson, *The World Trading System : Law and Policy of International Economic Relations* 11-12.
[90] David Ricardo, *Principles of Political Economy and Taxation* (ElecBook 2001); Jackson, *The World Trading System : Law and Policy of International Economic Relations* 15-16.
[91] Trebilcock, Howse and Eliason, *The Regulation of International Trade* 3-5; Mirela Keuschnigg, *Comparative Advantage in International Trade : Theory and Evidence* (Studies in empirical economics, Physica 1999).
[92] Eli F. Heckscher and others, *Heckscher-Ohlin Trade Theory* (MIT Press 1991); Keuschnigg, *Comparative Advantage in International Trade : Theory and Evidence* 7-11.

views cost as endogenously determined and predicts that a country will produce and export the commodity that intensively uses the factor which that the country has in abundance.[93]

However, the limitation of these theories is that the market is in perfect competition, i.e. producers believe that they can sell all their production at the market price and they cannot influence the fixing of such a price.[94] As mentioned before, in reality, this situation can hardly exist. More often, the market is in imperfect competition, where companies are aware that they can set the price of their products and will sell more if they reduce their prices.[95]

The theory of comparative advantage and the factor proportion hypothesis serve as the foundation to understand the economics of international trade, which is also the precondition for analyzing subsidies further.

2.2.2 Concept of subsidies

2.2.2.1 Economic and legal concepts of subsidies

The issue of subsidies has been discussed a lot, but it is still difficult to find a precise concept of subsidies.[96] To understand the concept, it is better to analyze it from both economic and legal perspectives. Because the concept can be very broad, the research focuses on understanding it within the scope of international trade and competition.

From the perspective of economics, subsidies are generally considered as a government transfer of money to an entity in the private sector or the provision of a good or service at a price below what a private entity would otherwise have to pay for it.[97] A subsidy may also be defined as any government program or practice that benefits certain enterprises or sectors and increases their profitability.[98] This section describes subsidies by firstly identifying certain features. A subsidy is a form of governmental action; forms of subsidies can be diverse; and the outcome of subsidies can benefit certain subjects, thus affecting competition in the international market and international

[93] Ibid.
[94] Krugman and Obstfeld, *International Economics : Theory & Policy* 121-122.
[95] Ibid.
[96] Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective* 41.
[97] Sykes, 'Subsidies and Countervailing Measures' 2.
[98] Sergio Alessandrini, 'Subsidies, Strategic Trade Policiese and the GATT' in Jacques H.J.Bourgeois (ed), *Subsidies and International Trade, A European Lawyer's Perspective* (Subsidies and International Trade, A European Lawyer's Perspective, Kluwer Law and Taxation Publishers 1991) 5.

trade, etc. In addition, subsidies usually have specific targets, i.e. specific sectors or industries in the market. [99]

From a legal perspective, although each state has its own regulations on subsidies, the lack of a unified definition of subsidy can cause misunderstandings and abuse of the application of those regulations. Therefore, the concept of a subsidy is defined respectively by the World Trade Organizations (WTO) and the European Union (EU), the two most developed systems for regulating this governmental measure internationally.[100] In the WTO, there is a set of rulings with respect to the regulation of subsidies, the main regulation of which is provided in the Agreement on Subsidies and Countervailing Measures (the ASCM). Under the ASCM, a subsidy is defined as a financial contribution made by a government or any public body which confers a benefit that is specific.[101] In the EU, a similar concept of subsidy is developed and referred to as State aid. A State aid means any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods and shall, in so far as it affects trade between Member States, be incompatible with the internal market.[102]

2.2.2.2 Nature of subsidies

(1) Governmental intervention into the economy via fiscal revenue

According to the theory of the market economy, under a market economy system, subsidies are the governmental use of fiscal revenue to intervene the economy.[103] Subsidies are funded from tax revenue paid by taxpayers, which can involve direct and indirect budgetary costs through forgone tax revenues. Therefore, the provision of subsidies is a redistribution of national income. [104]

(2) Instruments to achieve governmental objectives

Governments grant subsidies. From agovernment's perspective, subsidies are instruments used to achieve certain social or economic goals, such as adjusting resource allocation, boosting the

[99] Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective* 41-42.
[100] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 86-88.
[101] Article 1.1 of the ASCM.
[102] Article 107 (1) of the Treaty on the Functioning of the European Union (TFEU), Official Journal of the European Union, C 326/47, 26.10.2012.
[103] Sykes, 'Subsidies and Countervailing Measures' 85-86.
[104] Luengo Hernández de Madrid, *Regulation of Subsidies and State Aids in WTO and EC law : Conflicts in International Trade Law* 7.

economy, attracting investment, and improving equality. Subsidies are instruments.[105] There is a distinction between general subsidies and specific subsidies. Governments are free to offer general subsidies to industries, but, in reality, governments often grant subsidies to specialized sectors or activities. Specific subsidies reveal a government's particular objectives to support certain industries or regions.[106]

2.3 Tax incentives as subsidies

2.3.1 Concept of tax incentives

The concept of tax incentives is vague, but it has certain features. A common element in the notion is that there is a deviation from a benchmark tax system.[107] In the context of international trade, tax incentives normally target economic development.[108] They can be considered as a transfer of government revenue that is achieved by reducing tax obligations based on a benchmark tax system.[109] It does not require a direct grant of cash that may become a burden on fiscal expenditure. By using tax incentives, tax that otherwise would be due is foregone in the end.[110]

2.3.2 Tax incentives as subsidies

2.3.2.1 The term "tax incentives as subsidies"

Tax incentives are one of the most popular subsidy types used to grant financial assistance. When subsidies are in the form of tax incentives, the effects on international trade or international competition can be significant.[111]

It has to be clarified that not every tax incentive falls within the scope of subsidies. Similar to subsidies, tax incentives deviate from the normal benchmark and there is a distinction between general and specific tax incentives. If tax incentives are embedded in the tax law system and are

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[105] Trebilcock, Howse and Eliason, *The Regulation of International Trade* 364.

[106] Gustavo E. Luengo Hernandez de Madrid, 'Preliminary Remarks and Economic Analysis of Subsidies' in Gustavo E. Luengo Hernandez de Madrid (ed), *Regulation of Subsidies and State Aids in WTO and EC Law, Conflicts in International Trade Law* (Regulation of Subsidies and State Aids in WTO and EC Law, Conflicts in International Trade Law, Kluwer Law International , The Netherlands 2007) 13-14.

[107] OECD, *Tax Expenditures in OECD Countries* 16.

[108] Brauner, 'The Future of Tax Incentives' 25-26.

[109] Governments of developing countries especially tend to use tax incentives to attract foreign investment, particularly foreign direct investment (FDI). In that context, tax incentives for FDI mean a special tax provision is granted to qualified investment projects that represent a statutorily favorable deviation from a corresponding provision applicable to investment projects in general. See Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 15; Easson, *Tax Incentives for Foreign Direct Investment* 3.

[110] Pinto, *Tax Competition and EU Law* 2-3.

[111] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 6-9.

applied to all, the tax incentive is general. In contrast, if tax incentives are only limited to selected recipients, which deviates from the normal tax rules, these tax incentives can be regarded as specific. This research focuses on the analysis of tax incentives as subsidies in the context of international trade and competition, and therefore it focuses on specific tax incentives.

2.3.2.2 Reasons for governments to use tax incentives as subsidies

(1) Efficiency

Governments prefer to use tax incentives rather than direct subsidy instruments because they consider tax incentives to be more efficient than direct subsidies. This is especially the case in relation to developing countries when they intend to attract FDI.[112]

At the stage of legislation, it is possible to grant tax incentives faster compared to granting direct subsidies. The source of the financing of subsidies is tax revenue and subsidies are granted through the redistribution of national income. To grant direct subsidies, it always requires a budgetary scrutiny procedure. In fact, it becomes more and more difficult for governments to get approval for subsidy programs, especially in a period of a budget crunch or financial crisis.[113] Hence, by providing subsidies through tax incentives, the government does not have to go through an independent and time-consuming budgetary scrutiny procedure.[114] Although the lawmaking process itself may require a formal and complicated procedure as well, once it is stipulated in the tax legislation, the provision of tax incentives can be direct and efficient.[115]

At the stage of implementation, tax administrators are experts on tax issues, and they are well trained and fast to take action. Governments always trust tax administrations can achieve their policy goals by administering the implementation of tax incentives. The automatic implementation of tax incentives also results in efficient enforcement, since governments do not have to set up a special institution to carry out and supervise the subsidy programs. However, governments often overestimate the capability of tax administrations, thus overly relying on them to implement very

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[112] Ibid.

[113] Raymond Hubert Christiaan Luja, *Assessment and Recovery of Tax Incentives in the EC and the WTO : A View on State Aids, Trade Subsidies and Direct Taxation* (Intersentia 2003) 14.

[114] Countries that do not establish a tax expenditure system normally do not have budgetary control over the granting of tax incentives, especially developing countries. The major objective of offering tax incentives is to attract foreign direct investment. Thus, the granting of tax incentives does not always go through the budgetary process. See Brauner, 'The Future of Tax Incentives'.

[115] Luja, *Assessment and Recovery of Tax Incentives in the EC and the WTO : A View on State Aids, Trade Subsidies and Direct Taxation* 14.

technical and complex tax incentives. In such situations, tax administrations are overloaded and lack concrete guidance to perform. Since tax administrations have limitations as well, the efficiency of the tax incentives can be affected.[116]

(2) Flexibility

Another reason that governments prefer to use tax incentives is that they believe tax incentives are more flexible than direct subsidies.[117] For the recipients of tax incentives, there are various forms and levels of tax incentives that can be used individually or combined, thereby allowing individuals or firms to determine how much the particular activity is to be supported and how to maximize the benefits derived from using these instruments. Furthermore, taxpayers themselves can decide how to apply tax incentives to fit their interests best. In addition, payments to beneficiaries through the tax system are automatic, which seems more simplified for them.[118] Nevertheless, the so-called flexibility is not always flexible once tax incentives are stipulated in the legislation, as it is more difficult to alter tax laws than direct subsidy programs. The amendment of tax laws always has to go through the legislative process, while changing a direct subsidy program could take place within the government. [119]

(3) Transparency

To a certain degree, tax incentives can be considered less transparent than direct subsidies, and therefore, for governments, tax incentives might be less debated or investigated.[120] Direct subsidies are always controlled by a special entity in the government, thereby resulting in a higher administrative authority. This administrative entity can ensure stricter supervision of the outgoing capital for both the government and the beneficiaries.[121] With regard to the tax incentives, they do not always go through the supervision process required for direct subsidies. For instance, direct

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[116] Robert W. McGee, *Taxation and Public Finance in Transition and Developing Economies* (Springer 2008) 13.
[117] OECD, *Tax Expenditures : A Review of the Issues and Country Practices* (OECD 1984) 13.
[118] Easson, *Tax Incentives for Foreign Direct Investment* 2-3.
[119] However, tax incentives stipulated in tax laws are more stable and consistent than temporarily granted subsidy programs, resulting in more certainty for tax payers.
[120] Fiscal transparency becomes an increasingly important issue in the context of international tax competition. Countries are working closely together to make tax policies and information as transparent as possible. For instance, the OECD has consistently issued reports and proposals on increasing fiscal transparency globally. See OECD, *Tax Co-Operation 2010: Towards a Level Playing Field-Assessment by the Global Forum on Transparency and Exchange of Information* (OECD) 2010; OECD, *The Global Forum on Transparency and Exchange of Information for Tax Purposes* (OECD) 2013.
[121] Pinto, *Tax Competition and EU Law* 2.

subsidies always target particular subjects providing a specific preferential treatment, however, a tax incentive, for instance, might appear to apply in general to all subjects, but *de facto* it may only benefit certain taxpayers. The latter is obviously less transparent than direct subsidy programs, and this kind of tax incentive is regarded as a disguised subsidy. With the development of globalization, especially in the context of international trade, direct subsidies can easily be considered to be trade barriers, and therefore governments are gradually abolishing direct subsidy programs and creating more tax incentives to achieve certain objectives.[122]

However, it is not always the case that direct subsidies are more transparent than tax incentives, because, if tax incentives are to be stipulated in tax laws, the launch of new laws and the amendment of previous laws have to go through a formal and complicated procedure as well. This exposure can increase the transparency of new tax incentives.

2.3.3 Tax incentives and tax expenditures

The concept of a tax expenditure was firstly promoted by an American scholar Stanley Surrey in 1970, and it was widely accepted across countries.[123] The concept describes special tax provisions that represent government expenditures made through the tax system to achieve economic and social objectives. These special tax provisions provide deductions, credits, exclusions, exemptions, deferrals, and preferential rates, and serve the same purpose as direct government expenditures programs.[124]

Kraan (2004) defined a tax expenditure as "a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by a direct expenditure".[125] The most obvious feature in the notion is a deviation from a tax system benchmark.[126] The benchmark includes the rate structure, accounting conventions, deductibility of compulsory payment, provisions to facilitate tax administration, and international fiscal obligations, etc.[127]

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[122] Schön, 'World Trade Organization Law and Tax Law'.
[123] Stanley S. Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' (1970) 83 Harvard Law Review 705.
[124] Ibid.
[125] D. J. Kraan, D. J. Kraan, 'Off-budget and Tax Expenditures' (2004) 4 OECD Journal on Budgeting 121; OECD, *Tax Expenditures in OECD Countries* (OECD 2010) 14.
[126] Ibid 16.
[127] Zhicheng Li, Hana Polackova Brizi and Christian Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices' in Hana Polackova Brizi, Christian Valenduc and Zhicheng Li (eds), *Tax Expenditures--Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies* (Tax Expenditures--Shedding Light on Government

Governments do not bother to collect tax first and then distribute revenues again. Therefore, it can be less costly to the tax administration if the procedure is less complicated.[128]

It seems that tax incentives are similar to tax expenditures, but there are still differences between the two.[129] The term tax expenditure is from the government's perspective, which focuses more on national fiscal and budgetary control system. In contrast, the concept of tax incentives is more from the taxpayers' perspective, who are beneficiaries of the tax incentives. The establishment of tax expenditures actually aims at managing tax incentives from the budget, which is always subject to the authorization and supervision of the legislative authorities. Thus, it refers to a higher level in relation to the administration of tax incentives.[130] Accordingly, tax incentives are embedded in the national budgetary control system through tax expenditures, so the concept of tax incentives is included within the meaning of tax expenditures.[131] Additionally, tax expenditure is a more generalized and broader concept compared to tax incentives. Tax expenditures aim at providing general incentives for social or economic activities, but tax incentives can have more precise objectives, such as attracting investment and promoting particular sectors.[132]

2.3.4 Tax incentives as a method of tax competition

Governments usually introduce tax incentives to increase competitiveness in tax competition. Tax competition can be regarded as an outcome of the application of tax incentives by countries. As defined by Pinto (2003), tax competition is "the lowering of the tax burden in order to improve a country's economy and welfare by increasing the competitiveness of domestic business and/or attracting foreign investment."[133] It is also defined by Kiekebeld (2004) as "improving the relative competitive position of one country *vis-à-vis* other countries by reducing the tax burden on

Spending through the Tax System Lessons from Developed and Transition Economies, World Bank 2004) 3.

[128] According to the OECD report, there are different ways of estimating the cost of tax expenditures, including calculating the revenue forgone, the revenue gain, and the outlay equivalence approach. See OECD, *Tax Expenditures in OECD Countries* 14-15; OECD, *Tax Expenditures : A Review of the Issues and Country Practices* 19.

[129] Chapter 6 contains a further analysis of tax incentives and tax expenditures.

[130] Mark Burton and Kerrie Sadiq, *Tax Expenditure Management a Critical Assessment* (Cambridge University Press 2013) 2-3.

[131] Li, Brizi and Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices' 4.

[132] Tim Edgar, 'Financial Instability, Tax Policy, and the Tax Expenditure Concept' (2010) 63 Southern Methodist University Law Review 969.

[133] Pinto, *Tax Competition and EU Law* 1.

business and individuals in order to remain, gain or regain mobile economic activities and the corresponding tax base, whether at the expense of other countries or otherwise".[134] In general, tax competition exists when enterprises or individuals can reduce tax burdens by shifting capital or labor from high-tax jurisdictions to low-tax jurisdictions.[135]

The main classification of tax competition is vertical tax competition and horizontal tax competition.[136] The former means competition between governments of different levels, such as between the central government and the local government. Horizontal tax competition means tax competition between different countries or competition between governments, such as tax competition between the Member States in the EU.[137]

In an international context, countries involved in tax competition intend to achieve certain goals, such as increasing their international competence. This also implies a way of classifying tax competition, i.e. inbound tax competition to attract foreign investment or capital, and outbound tax competition to stimulate domestic economy and encourage exportation.[138]

Tax competition flourishes with the development of globalization.[139] Historically, tax policies primarily address domestic economic and social concerns, but the globalization of trade and investment has increased the potential impact that domestic tax policies can have on other economies. It has led to increased competition among businesses in the global market.[140] Multinational enterprises (MNEs) and investors are free to choose among various countries systems. Therefore, with the internationalization of MNEs and their cross-border transactions, tax competition is becoming more and more fierce and advanced.[141]

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[134] B. J. Kiekebeld, *Harmful Tax Competition in the European Union : Code of Conduct, Countermeasures and EU law* (Foundation for European Fiscal Studies, Kluwer 2004) 8-9.
[135] Daniel J Mitchell, 'The Economics of Tax Competition: Harmonization vs. Liberalization' (2004) 25 Index of Economic Freedom, Heritage Foundation 38.
[136] Pinto, *Tax Competition and EU Law* 2.
[137] Ibid.
[138] Ibid.
[139] Ibid.
[140] OECD, *Harmful Tax Competition, An Emerging Global Issue*.
[141] Markus Leibrecht and Claudia Hochgatterer, 'Tax Competition as a Cause of Falling Corporate Income Tax Rates: A Survey of Emperical Literature' (2012) 26 Journal of Economic Surveys 616.

2.4 Rationale for granting tax incentives as subsidies

Governments grant tax incentives and they do so with certain economic or social objectives. The rationale for them to grant tax incentives is that they believe such powerful instruments are helpful to achieve their goals. Indeed, according to economic theories, tax incentives can bring benefits, thereby realizing governments' policy goals. Moreover, tax incentives, as a government's intervention into the market, can increase economic efficiency under specific conditions. The economic analysis on tax incentives shows the positive effects of tax incentives. In order to present the effects of tax incentives, it is assumed that there are three main actors in the market: governments as the incentive providers, producers (firms) as the incentive receivers, and consumers as third parties whose interests are affected. The analysis of the rationale is from both efficiency and equity perspectives, based on the relationship between market, trade, and competition that has been discussed. Considering the specific and direct influence of tax incentives on tax competition, the analysis also addresses the effects on tax competition.

2.4.1 Efficiency rationale

2.4.1.1 Correcting market failures

Tax incentives are an instrument used by governments to influence the market. Governments always find justifications for granting tax incentives namely as correcting market failures.

Firstly, tax incentives can reallocate resources properly.[142] One form of market failure is an imbalance between demand and supply, i.e. the amount of goods and services on the market outweighs the consumption ability or vice versa. In this situation, tax incentives can adjust the imbalances by stimulating the production when there is short supply or by controlling the production in oversupply.

Secondly, governments can sponsor investments in industries that require large amounts of money and in which private enterprises usually will not invest.[143] It is especially important to subsidize activities such as employment, research and development (R&D) development, and the protection of environment etc. In addition, the public goods that the market cannot provide can also be offered through governmental subsidization.

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[142] Skyes, *Subsidies and Countervailing Measures* 88-89; Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 24-25.

[143] Jacques Derenne and Massimo Merola, *Economic Analysis of State Aid Rules : Contributions and Limits* (Lexxion 2007) 18.

The ultimate goal of correcting market failures is to increase domestic market efficiency. Governments adopt tax incentives to improve domestic market efficiency, which contributes to the country's competitiveness in foreign markets.[144] For example, when domestic efficiency has improved, domestic enterprises tend to export, especially when there is over capacity in the domestic market. However, facing protectionism in the importing country, export subsidies are able to assist domestic producers to re-establish a competitive status in the foreign market.[145]

2.4.1.2 Supporting infant industry

Granting protective tax incentives to domestic infant industries can help start-ups to take the time to grow stronger.[146] Tax incentives may reduce their costs of production and stimulate them to expand production or to make decisions to enter or exit a market. With the increase of their production, infant industries can even grow faster than mature competitors. To a certain degree, without tax incentives, a producer may not expand its production because it would not be profitable. However, when other conditions remain the same, a tax incentive may make it profitable for the producer to invest in new production or to invest in foreign markets.[147] In the long run, this kind of subsidy will assist domestic producers to participate more and even enjoy a beneficial status in foreign markets.

It is obviously beneficial for governments because they appreciate the associated outcome derived from the growth of those infant industries, such as technology transfer, increase of employment, and improvement of core competences, etc..[148]

2.4.1.3 Strategic trade theory

Strategic trade theory was promoted by Barbara Spencer and James Brander (1986),[149] who reviewed subsidies according to the maximization of national welfare. According to Spencer and

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[144] Karl D. Meilke and John Cranfield, 'Production Subsidies' in Willian A. Kerr, James D. Gaisford and Estey Centre for Law and Economics in International Trade (eds), *Handbook on International Trade Policy* (Handbook on International Trade Policy, Edward Elgar Publishing 2007) 293-294.
[145] Coppens, *WTO Disciplines on Subsidies and Countervailing Measures* 8-9.
[146] Josh Ederington and Phillip McCalman, 'Infant industry protection and industrial dynamics' (2011) 84 Journal of International Economics 37.
[147] However, subsidies may have no impact on the output of recipients if they are not used in the intended way. Neven and Verouden, 'Towards a More Refined Economic Approach in State Aid Control' 48.
[148] Trebilcock, Howse and Eliason, *The Regulation of International Trade* 9-10.
[149] Barbara J.Spencer, 'What Should Trade Policy Target?' in Paul R. Krugman (ed), *Strategid Trade Polich and the New International Economics* (Strategid Trade Polich and the New International Economics, the MIT Press 1986) 69; James A. Brander, 'Rationales for Strategic Trade and Industrial Policy ' in Paul R. Krugman (ed), *Strategic Trade Polich and the New International Economics* (Strategic Trade Polich and

Brander, because of imperfect competition in the international market, many industries gain significant profits. Using subsidies, governments can encourage resources flowing to certain domestic sectors, thereby increasing the strategic advantages in those sectors and shifting those international profits to domestic firms, consequently increasing domestic income.[150]

From a dynamic analysis, domestic tax incentives may have the objective effect of reducing the net costs of production, which could also stimulate the exportation of those products. As a result, the expansion of exports can assist the domestic producers to accumulate capital, improve technology, accumulate resources, and accordingly improve the overall welfare.[151]

2.4.2 Equity rationale

Tax incentives not only can improve efficiency in the market, but they can also readjust inequities. They work as instruments for governments to redistribute social welfare and adjust inequalities. For example, , private investors are rarely willing to invest in underdeveloped regions without preferential incentives such as regional tax incentives, since it is difficult to generate revenues in such regions, compared to investing in developed regions where the market and resources are better. However, if governments can offer tax incentives for investment in those underdeveloped regions, the situation may be changed. Also, as a method redistributing national income, the use of tax incentives can support the establishment of public infrastructure and services and reduce inequity between different regions. [152]

2.4.3 Sound tax competition

When considering the effects on tax competition, the above-mentioned rationale is the same for countries to grant tax incentives.

High tax rates may inhibit economic growth, but tax competition, which encourages lower tax rates, could be beneficial to the economy. This is known as the Tiebout hypothesis.[153] This

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the New International Economics, the MIT Press 1986) 23; Trebilcock, Howse and Eliason, *The Regulation of International Trade* 10-11.

[150] Ibid.

[151] Ibid.

[152] Andrew Hanson and Shawn Rohlin, 'Do Location-based Tax Incentives Attract New Business Establishments?' (2011) 52 Journal of Regional Science 427; Alexandre Porsse, Eduardo Haddad and Eduardo Pontual Ribeiro, 'Economic Effects of Regional Tax Incentivs: A General Equilibrium Approach' (2008) Latin American Business Review 195.

[153] Charles M. Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 Journal of Political Economy 416-424.

hypothesis argues that competition for mobile households is welfare enhancing and subsequent work has applied similar ideas to competition for mobile firms. The hypothesis also deals with the idea of "voting with one's feet", i.e. households and firms leave the jurisdiction of a particular tax authority if they feel that the tax burden is too great in that jurisdiction. The taxpayers decision-making process can stimulate the provision of local public goods according to the taste of residents.[154]

Sound tax competition means that a general reduction of the tax burden is usually acceptable if it is directed towards internal tax efficiency and improving a country's attractiveness compared to other countries.[155] Tax competition can facilitate economic growth by encouraging governments to adopt reasonable tax policies. Moreover, sound tax competition forces governments to maintain reasonable levels of public expenditure and improves the efficiency of the public administration, leading to a reduction of its size in relation to public services. [156]

In summary, sound tax competition is beneficial given that it prevents high tax rates and low efficiency, and it promotes investment and economic growth. It also stimulates productivity and innovation.[157] Tax competition puts pressure on states to become more efficient with regard to how they raise and spend taxes. Therefore, it can provide a better economic environment at the lowest possible tax cost.

2.5 Rationale for regulating tax incentives as subsidies

Economics are in dynamics. Although governments claim the beneficial effects of tax incentives as reasons for granting them, the actual effects can be contradictory. Therefore, the alleged benefits can turn into harms or negative effects. The following sections demonstrate that the alleged benefits mentioned above are likely to be harmful for other market participants or even for the governments themselves. By analyzing the adverse effects of tax incentives, it is much clearer to assess tax incentives and the rationale for regulating them.

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[154] Willem Vermeend, Rick van der Ploeg and Jan Willem Timmer, *Taxes and the Economy : A Survey of the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (Elgar 2008) 267.
[155] Schön, *Tax Competition in Europe* 7.
[156] Pinto, *Tax Competition and EU Law* 8.
[157] Patricia Lampreave, 'Fiscal Competitiveness versus Harmful Tax Competition in the European Union' (2011) 65 Bulletin for International Taxation 5.

2.5.1 Efficiency rationale

2.5.1.1 Distortion caused by correcting market failures

(1) Distortion of resource allocation

Tax incentives can artificially change the comparative advantage of a country, producing an inefficient allocation of resources.[158] In a country's domestic market, for instance, if a government provides a tax incentive to the producer of a certain good, the incentive reduces the cost of production. However, resources are employed to produce selected goods rather than other goods of greater value. As a result, such resources are not allocated most efficiently, since they are not allocated to their most productive use.

Moreover, in the international market, tax incentives, especially export-oriented incentives, divert resource allocation in the importing country's market.[159] Thus, tax incentives reduce global welfare by promoting the production of goods in one country that another country could have produced more efficiently, leading to lower economic welfare worldwide. From this perspective, tax incentives are assumed to "tilt the playing field" as opposed to maintain a "level playing field".[160]

(2) Distortion effects on third countries

Products with export subsidies to a foreign country not only affect the importing country itself, but they also influence other countries in the international market.[161] For example, Country A exports to Country B, meanwhile, Country C also exports to Country B. When Country A provides subsidies to its domestic enterprises exporting to Country B, Country B can take countermeasures towards Country A when encountering distortion and a reduction of welfare to counteract the subsidy influence caused by Country A. However, as a competitor of Country A, Country C cannot compete with Country A's enterprises. As a result, the enterprises of Country C may exit from Country B's market. Consequently, Country C's producers will encounter losses that cannot be compensated by Country B's countermeasures.[162] Hence, subsidies can create new market failures

[158] Skyes, *Subsidies and Countervailing Measures* 90-91.
[159] Jr. Warren F. Schwartz and Eugene W. Harper, 'The Regulation of Subsidies Affecting International Trade' (1971-1972) 70 Michigan Law Review 840.
[160] Charles J. Goetz, Lloyd Granet and Warren F. Schwartz, 'The Meaning of 'Subsidy' and 'Injury' in the Countervailing Duty Law' (1986) 6 International Reveiw of Law and Economics 17.
[161] Madrid, 'Preliminary Remarks and Economic Analysis of Subsidies' 24.
[162] Alan O.Skyes, 'Countervailing duty law: an economic perspective' (1989) 89 Columbia Law Review 199-263.

in another market or just transfer those failures to other countries. As a whole, they do not solve the problem, but they can create new distortions and welfare losses.

(3) Governmental failures

The decisions of governments may bring about detrimental outcomes. Usually, when private choices face failures, they are easily adjusted since the scale is always small; however, public choices by governments are more difficult to change or abandon if the scale is large and the effects are concentrated in certain sectors or activities.[163] Once the effects of subsidies cannot be controlled well, the distortion and social welfare losses may be more severe than the original market failures.

In addition, government intervention is costly and its administrative costs may exceed the benefits of correcting the market failures.[164] The decision can also be taken on misinformation if regulators have less information than market participants have. Above all, governments are in principle as self-interested as market participants are, and therefore they might be more concerned with maximizing their private utility than the welfare of whole society.[165] Therefore, the efficient correction of market failures actually depends on the correction cost.

Furthermore, excessive government intervention can also trigger political lobbying and corruption that may easily cause power rent-seeking. [166] For example, interest groups can influence governments to adopt their suggestions on tax incentives, which mainly represent their interests developed via lobbying and financial sponsorship. Consequently, the use of tax incentives for

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[163] Jacques H.J. Bourgeois, *Subsidies and International Trade, A European Lawyers' Perspective* (Kluwer Law and Taxation Publishers 1991) 15.

[164] Warren F. Schwartz and Eugene W. Harper, 'The Regulation of Subsidies Affecting International Trade' 831, 849.

[165] Alessio M. Pacces and Louis Visscher, 'Law and Economics, Methodology' in Bart van Klink (ed), *Law and Method: Interdisciplinary Research into Law* (Law and Method: Interdisciplinary Research into Law, Mohr Siebeck 2011) 100; Johan Den Hertog, 'General Theories of Regulation' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics / Vol 4, The Economics of Public and Tax Law* (Encyclopedia of Law and Economics / Vol 4, The Economics of Public and Tax Law, Elgar 2000) 223-270.

[166] The brief theory of rent-seeking is that resources can be used unproductively to seek unearned personal benefits. It was introduced in economic analysis by Gordon Tullock in 1967. See Gordon Tullock, 'The Welfare Costs of Tariffs, Monopolies, and Theft' (1967) 5 Western Economic Journal 224-232; Arye L. Hillman, 'Rents and International Trade Policy' in Roger D. Congleton and Arye L.Hillman (eds), *Companion to the Political Economy of Rent Seeking* (Companion to the Political Economy of Rent Seeking, Edward Elgar Publishing 2015) 187-202.

certain sectors or activities is not always based on the consideration of social welfare or domestic efficiency, but instead, it is affected by special interest groups. On the other hand, the lobbying of related interest groups can also easily result in corruption.[167] Therefore, the results of governmental failures can be more severe than market failures.

2.5.1.2 Side effects of supporting infant industries

As analyzed before, tax incentives can help start-ups to learn and grow more quickly. However, infant industries may eventually grow into mature industries, and they can enjoy a more advantageous competition status in the domestic market with continuous subsidies.[168] Moreover, subsidies protect infant industries from pressure from competition in the market, and cause them to lack the motive to innovate.[169] In this situation, the extreme case could be that enterprises would be more reliant on governmental support, resulting in enterprises that otherwise would be out of the market continue to be able to stay on the market. This is an artificially caused deviation from market rules, which means that, once subsidies are cancelled, those enterprises may end up in a worse-off situation.[170]

Tax incentives can also result in protectionism. In the long run, infant industries with subsidies are likely to form monopolies in the market and make domestic consumers worse off.[171] Provided that other conditions on the market do not alter, in this case, other competitors may gradually leave the market or be left with only a small share of the market. Hence, the subsidized producers are likely to be able to manipulate the price of products, thereby affecting customers' welfare.[172] However, this situation appears only under the assumption that the tax incentive is the only variant that affects the market position of enterprises, while other variants stay stable. In reality, this situation will rarely exist, but the role tax incentives play should not be neglected.[173]

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[167] Ibid.
[168] Robert E. Baldwin, 'The Case against Infant-Industry Tariff Protection' (1969) 77 Journal of Political Economy 295.
[169] Ibid.
[170] Ha-joon Chang, 'Kicking away the Ladder: Infant Industry Promotion in Historical Perspective' (2003) 31 Oxford Development Studies 21.
[171] Madrid, 'Preliminary Remarks and Economic Analysis of Subsidies' 23-24.
[172] Baldwin, 'The Case against Infant-Industry Tariff Protection' 298-299.
[173] Krugman and Obstfeld, *International Economics : Theory & Policy* 202.

2.5.1.3 Strategic trade policy leading to game theory

Subsidies granted in the name of strategic trade policies can turn into a prisoner's dilemma,[174] which makes both subsidized and unsubsidized parties worse off.[175]

		No Subsidy	Subsidy
Country B		400	500
	No Subsidy	400	50
Country A		50	100
	Subsidy	500	100

Diagram 1[176]

Supposing that there are two countries in the market, Country A and Country B, the use of export subsidies as a strategic trade policy can be illustrated in the following three situations:

(1) One country grants subsidies while the other does not. For instance, Country A subsidizes domestic enterprises to export to Country B, but Country B does not have countermeasures. It can be speculated that the enterprises of Country A would be better off in the market of Country B, because, with Country A's subsidies, products can enter B's market with more competitive prices, and therefore will occupy larger market shares. In the long run, they can also force enterprises without B's subsidies to withdraw from the market. From the perspective of international trade, A would be better off, but B would incur losses. Vice versa, if Country B provides export subsidies to products entering Country A's market, the result is the same. B will be better off by sacrificing A's benefits.

(2) Both countries grant subsidies. In this case, suppose that Country A grants export subsidies to domestic products exporting to Country B. However, Country B has an identical strategy

[174] The prisoner's dilemma is a typical example of a game in game theory explaining the reasons why two persons might not cooperate, even if it appears to be in their best interest. Albert W. Tucker coined the term when he discussed his graduate student John F. Nash's work in a lecture in 1950. See Martin Peterson, *The Prisoner's Dilemma* (Cambridge University Press 2015) 1-2.

[175] Brander and Spencer used the competition between Boeing (US) and Airbus (EC) as an example to illustrate strategic trade policies. See Brander, 'Rationales for Strategic Trade and Industrial Policy ' 36-37; Robert E. Baldwin, 'The Political Economy of Trade Policy' (1989) 3 The Journal of Economic Perspectives 119, 126.

[176] This paragraph is a modified version from Baldwin's analysis. See Baldwin, 'The Political Economy of Trade Policy' 126.

towards Country A, namely, export subsidies provided to domestic products exporting to Country A and protective subsidies to local enterprises to compete with A's subsidized products. In the end, the situation can develop into a trade war. Consequently, neither A nor B could gain advantages in the international market, as both of them would end up worse.

(3) Neither country grants subsidies. Without the use of subsidies, trade between Country A and Country B just follows the theory of comparative advantages and free-market theory. Nevertheless, either Country A or Country B should try to avoid becoming the first grantor of subsidies in order to gain unilateral advantages. Otherwise, the result will evolve into the situations mentioned in (1) or (2).

In the situation of tax incentives as export subsidies, domestic products can enter a foreign market with lower prices, which may benefit foreign consumers in general.[177] Nevertheless, foreign local producers may have an opposite attitude, because they encounter unfair competition. Without the same subsidization, local competitors cannot afford to have prices of products as low as the subsidized imported products; consequently, they may exit the market.[178] However, in the long run, tax incentives as export subsidies can still damage the consumers' welfare since, when competitors exit the market, there is an increasing dependence on subsidized imported products and the producers are subsequently able to act as monopolies.[179] In this case, subsidies can be used as a form of predatory competition, i.e. the prices of the subsidized products are very low so that other competitors in the market would not be able to compete.[180]

[177] Export subsidies and tariffs are relative concepts. Tariffs are applied by levying taxes to increase a product's cost for the importing country, which undermines the competitiveness of the product and eventually restricts importation for the importing country. Subsidies are similar to negative tariffs, which means decreasing the product's cost artificially to strengthen the competence on a foreign market. See Geoffrey Denton, Sally Ash and Seamus O'Cleireacain, *Trade Effects of Public Subsidies to Private Enterprise* (The Macmillan Press Ltd 1975) 10-14.

[178] The producer is the only supplier of the particular product in the market and there is no competition in the market. See Krugman and Obstfeld, *International Economics : Theory & Policy* 184.

[179] In reality, this is difficult because, even if the producer is successful in driving out its current competitors, it may face competition from new competitors. See Trebilcock, Howse and Eliason, *The Regulation of International Trade* 180-181.

[180] If predatory action causes consumers to be hostages of monopolists, while local producers have difficulty re-entering the market, the consumers are obviously worse off since they have no better choices. Nevertheless, it is also observed that there is little empirical basis for allegations of predation in international trade. See ibid 214; Daniel A. Crane, 'Paradox of Predatory Pricing' (2005) 91 Cornell Law Review 1-66.

From a dynamic perspective, the strategic trade policy not only damages the country who grants the subsidies but it also distorts competition and results in a reduction of global welfare. What is worse, if there is no control of the use of subsidies, more and more countries would be involved in upgrading the subsidy-granting competition, which can eventually make all the participants worse off and impair global welfare.

2.5.2 Equity rationale

Despite that the objective of subsidies is to remove inequality between individuals, enterprises, and regions, the effect or the result can be unequal. This is because subsidies are not granted to all but only to a selected group of individuals or enterprises. The selective nature means that it has to distinguish between different potential recipients. Indeed, the selected groups might originally be in a disadvantageous position and subsidies just help to readjust their impartial position. However, subsidies could also result in a new situation of inequality.

Tax incentives for specific regions can lead to regional tax competition.[181] Governments provide tax incentives in less-developed regions with the purpose of attracting investment to the regions that could bring more capital, technology, and employment, etc. However, even within a country, different regions compete on a horizontal level, and this is especially the case in federal countries. States launch various tax incentives to draw investment and resources. Regions that have the government's support are likely to be better off. In the long run, if they continue to enjoy those incentives, the level playing field is tilted again. In order to compete with these regions, other regions have to grant more tax incentives, which may end up with the worst situation in a prisoner's dilemma.

In addition, most tax incentives aim at the attraction of FDI to the domestic market, thus offering preferential treatment to foreign enterprises. This is especially typical in developing countries.[182] Nevertheless, this action harms the equity between domestic and foreign enterprises. Foreign enterprises are able to enjoy public goods without contributing significantly to their financing through corporate tax, but domestic enterprises who do not have access to those incentives must

[181] Fiona Wishlade, 'When Policy Worlds Collide: Tax Competition, State Aid, and Regional Economic Development in the EU' (2012) 34 Journal of European Integration 585.
[182] Brauner, 'The Future of Tax Incentives' 25-26.

pay for the revenue loss resulting from the incentives to those foreign enterprises. This situation eventually distorts the fair competition between domestic and foreign enterprises.[183]

Furthermore, although governments intend to use tax incentives to improve equality, it is critical to analyze who is the real beneficiary. From the government's point of view, tax incentives are aimed at the taxpayers, and particularly the high-income taxpayers. They provide most benefits to wealthy taxpayers and non-taxpayers do not benefit. Only eligible taxpayers can benefit from those tax incentives; this upside-down effect can cause the same problem as unequal treatment.[184]

2.5.3 Harmful tax competition

Another reason to restrict the use of tax incentives is harmful tax competition. According to the OECD report on harmful tax competition, "harmful" features can be listed as: no or low effective tax rates; "ring-fencing", i.e. specific tax incentives for foreign taxpayers; lack of transparency; lack of effective exchange of information; artificial definition of the tax base; failure to adhere to generally accepted transfer pricing principles; exemption of foreign-source income; negotiable tax rate or tax base; secrecy provisions; treaty network; and active promotion of tax scheme.[185]

The EU has a similar standard for identifying harmful tax measures, which is in the 1997 EU Code of Conduct. It includes an effective level of taxation considerably lower than the general level of taxation in the country concerned; tax advantages that are granted only to non-residents; tax incentives for activities that are isolated from the domestic economy and, therefore, have no effect on the national tax base; the granting of tax advantages without any real economic activity and substantial economic presence; a basis for the profit determination for companies that departs from internationally accepted rules, particularly those approved by the OECD; and a lack of transparency.[186]

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[183] Easson, *Tax Incentives for Foreign Direct Investment* 65.

[184] Neil Brooks, 'The Tax Expenditure Concept' (1979) January Canadian Taxation 33. The author explains the upside-down effect using the example of a tax deduction for childcare expenses. The more the taxpayer earns, the more that can be deducted. On the contrary, if the taxpayer's earning is below the deduction level, the deduction is of no value to that person. Therefore, tax incentives provide most benefits to the well-to-do. See also, Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' 722-723.

[185] OECD, *Harmful Tax Competition, An Emerging Global Issue* 26-29.

[186] EU Code of Conduct (1997): Conclusion of the ECOFIN Council meeting on 1 December 1997 concerning taxation policy DOC 98/C2/01, OJC2 (1998).

Tax competition can result in a "race to the bottom". As discussed before, countries always employ tax incentives to attract foreign investment. This method creates opportunities for enterprises to shift investments much more easily throughout the world. However, countries compete to draw investments flowing into the domestic market at the expense of other countries' opportunities of gaining tax revenues.[187] This consistent competition leads to a "race to the bottom", which can also be explained by a prisoner's dilemma. Without exchange of information and a consistent agreement on a coordinated approach, when facing this competitive rivalry, countries feel forced to keep their special tax incentives and countermeasures, but the situation damages the interests of all the parties. Eventually, everyone ends up poorer.[188]

To summarize, when harmful tax competition occurs, investors may modify their decisions in order to take advantage of incentives, thus resulting in a misallocation of resources. It has further potential to cause countries to race to the bottom, after which every party is worse off. It also distorts fair competition between firms with and without the incentives.

2.6 Matrix: comparing the rationale for granting and regulating tax incentives

Rationale for granting tax incentives as subsidies: benefits		**Rationale for regulating tax incentives as subsidies: distortions**
Efficiency rationale	1. Correcting market failures: a. Allocate resources properly b. Support large investment c. Increase domestic market efficiency	1. Distortion caused by correcting market failures: a. Distortion of resource allocation b. Distortion effects on third countries c. Governmental failures
	2. Supporting infant industries: Infant industries can grow into mature industries	2. Side effects of supporting infant industries: Preferential position, protectionism, monopoly
	3. Strategic trade theory: Support exportation, better position in the international market	3. Strategic trade policy leading to game theory: Game theory: prisoner's dilemma Tax competition: race to the bottom

[187] OECD, *Harmful Tax Competition, An Emerging Global Issue* 34.

[188] Ibid; Pinto, *Tax Competition and EU Law* 9. Some authors argue that, in reality, a race to the bottom does not really happen based on some empirical studies. Countries, especially welfare states, face other problems, such as unemployment, social security issues, and public goods, which counterbalance the effects of harmful tax competition. See Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 Harvard Law Review 1575; Philip Genschel, 'Globalization, Tax Competition, and the Welfare State' (2002) 30 Politics & Society 245; Philipp Genschel and Peter Schwarz, 'Tax Competition: A Literature Review' (2011) 9 Socio-Economic Review 339.

Equity rationale	Improve equity: e.g. decrease regional disparity	Create new inequality due to selectivity
Tax competition	Sound tax competition: Increase efficiency and equity Lower tax rates Better allocation of national income	Harmful tax competition: Decrease efficiency and equity Inefficient resource allocation Race to the bottom Unfair competition

2.7 International legal regulation of tax incentives

2.7.1 Benchmarks for regulation: efficiency and equity

Previous analysis shows that tax incentives can have both beneficial and adverse effects based on the benchmark of efficiency and equity in the market. As discussed, the relationship between market, trade, and competition serves as the basis and context for understanding the effects of tax incentives. Although the evaluation of a certain tax incentive is carried out on a case-by-case basis,[189] efficiency and equity in the market are general benchmarks for introducing regulations on tax incentives. The operation of the market, especially in the context of international trade and competition, requires that governmental intervention causes as little harm as possible, considering the increase of market efficiency. Moreover, since competition enhances efficiency, in order to maintain a level playing field for competition, the distortionary effects of tax incentives should also be controlled. This is also the requirement of achieving distributional equity in society by regulating the abuse of tax incentives.

2.7.2 Regulating the harmful effects of tax incentives

Due to the potential harmful effects of tax incentives in the context of international trade and competition, it is necessary to regulate the use of tax incentives. Economics is in flux, which means that a tax incentive granted with the objective to increase efficiency or equity in the market can still bring adverse effects to the market, trade, and competition. This is evident in the previous sections.

The regulation of tax incentives actually aims at their regulation of the harmful effects. When determining the regulation of the harmful effects, normally there are three situations: the tax incentive generates benefits and brings little or no harm; the tax incentive leads to harm, but balancing the harm with the benefits, the harm is affordable since the overall benefits are higher;

[189] As admitted by economists, there is no unique factor to evaluate the effects, since many economic factors combine to influence the effects of a tax incentive. See Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 30.

harm caused by the tax incentive outweighs the benefits.[190] The regulation interferes more in the latter two situations when the harm caused by the tax incentives substantially affects trade and competition in the market and further damages economic efficiency and equity.

2.7.3 Legal regulation based on the rule of law

Regulation here means legal regulation, which imposes restrictions on governmental behaviors. The market economy is actually a rule of law economy.[191] The key feature of the market economy is private ownership, i.e. resources are owned by private individuals. It makes both trading parties better off.[192] Economic interest is very important for individuals and personal choice is the basis of transactions. Thus, the proper functioning of the market requires a guarantee of effective laws and institutions that restrain the discretionary power of governments. The rule of law provides the basic guarantee that has replaced the social order of human relationships.[193] In order to limit the harmful effects of tax incentives, governments should be subject to the rule of law.[194]

The rule of law is a very broad and intensive concept, which reflects different values in different social circumstances.[195] However, it is commonly acknowledged that the threshold conditions of the rule of law are to restrain the arbitrary and inequitable use of state power and to protect individual rights.[196] In an economic context, a government's behavior is regulated by the rule of law which ensures efficiency in the market, since it entails freedom of entry into the market, access

[190] Report by the Office of Fair Trade, 'Guidance on How to Assess the Competition Effects of Subsidies', January 2007, OFT 829.
[191] Whish and Bailey, *Competition Law* 19-15; Taylor, *International Competition Law : A New Dimension for the WTO?* 20-32; Samuel Bufford, 'International Rule of Law and the Market Economy' (2006) 12 Southwestern Journal of Law and Trade in the Americas ; Pierre Dhonte, *Towards A Market Economy Structures of Governance* (International Monetary Fund 1997).
[192] Russell S. Sobel, 'Welfare Economics and Public Finance' in Jürgen G. Backhaus and Richard E. Wagner (ed), *Handbook of Public Finance* (Handbook of Public Finance, Kluwer Academic Publishers 2004) 21-22.
[193] Eva Huang and Bin Yang, 'Characteristics of the Chinese Tax System and Its Cultural Underpinnings: A Comparison with the West' (2011) 1 Journal of Chinese Tax and Policy 29-30.
[194] Further discussion on the relationship between the market and the rule of law is covered in Chapter 5.
[195] For instance, according to the history of countries, there are four typical types of the rule of law, including the English rule of law, the North American version of the rule of law, the German *Rechtsstaat*, and the French *État de droit*. See Pietro Costa, Danilo Zolo and Emilio Santoro, *The Rule of Law History, Theory and Criticism* (Springer 2007) 7.
[196] The emphasis of the protection of individual rights thrived after the Enlightenment, which then became the values of the law. See Adriaan Bedner, 'An Elementary Approach to the Rule of Law' (2010) 2 Hague Journal on the Rule of Law 48.

to relevant information, and the security of contracts.[197] Based on the basic theory of public finance, in the field of taxation, governments should confine the main economic functions to the stabilization of economic activity, redistribution of income and wealth, and the allocation of resources, so that the market still functions as the major actor in allocating resources.[198] A rule-based system can increase the transparency and accountability of governments and minimize the harmful effects caused by government intervention into the market.[199] In order to control the harmful effects of tax incentives, the legal regulation normally entails both ex-ante and ex-post assessment.[200] Ex-ante assessment means that, before introducing a tax incentive, governments should estimate the effects of the incentive according to certain legal and economic criteria. Ex-post assessment refers to the termination of tax incentives after periodical reviews on their effects. If there is no renewal, they should be terminated. Further analysis on the rule of law regulation of tax incentives will be addressed in Chapters 6 and 7.

2.7.4 International regulation

Considering the cross-border or supranational effects of tax incentives, it is important to determine the supranational or international regulation of those incentives.[201] In the context of international trade and competition, one country's tax incentives affect other countries' status of competition on the international market. Regardless of which justification is given for granting tax incentives, they can all lead to distortions in other countries. Particularly, in the specific context of tax competition, the abuse of tax incentives becomes an international issue that requires international regulations.[202] The race to the bottom is a typical example which results from harmful tax competition internationally. All countries would be better off if they would cooperate on an international level. Therefore, based on the benchmark of promoting economic efficiency and equity in the international market, it is necessary to regulate the harmful supranational effects of tax incentives.

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[197] Dhonte, *Towards A Market Economy Structures of Governance* 3.
[198] Richard Abel Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill 1973).
[199] The rule of law actually plays a role of balancing the power of the market and the government, but not definitely opposing the two. See Joseph E Stiglitz, *The Role of Government in Economic Development* (Washington DC: World Bank 1997).
[200] Easson, *Tax Incentives for Foreign Direct Investment* 158.
[201] L. Hancher, T. Ottervanger and P.J. Slot, *EU State Aids* (Sweet & Maxwell 2012) 32-34.
[202] OECD, *Harmful Tax Competition, An Emerging Global Issue* 13-18.

Additionally, one country's domestic interest groups have less chances to influence the rules and institutions on the international level, and therefore the international regulations create rather a fair platform for competition.[203] This serves the equity objective in relation to the regulation of tax incentives, which reduces governmental failures that usually occur domestically.

Internationally, there are two major legal systems that regulate governmental actions that create trade barriers or affect competition in the market. The WTO and the EU, the most developed international organizations in the area of international or transnational trade, have specific regulations on subsidies, with the focus on taxation.[204] The following chapter introduces and analyzes these two legal systems more in depth.

2.8 Conclusion

Governments use tax incentives as subsidies to achieve different objectives, such as correcting market failures, supporting infant industries, stimulating exportation, attracting FDI, and improving equality. Indeed, they play a role in realizing these goals and bring with them beneficial effects, which become the main reasons for governments to employ such instruments. However, economics is constantly in flux. The analysis on effects of tax incentives also demonstrates harmful effects with respect to efficiency and equity in the market. The alleged benefits pursued by governments can nevertheless cause disadvantages. Tax incentives aiming at correcting market failures can cause worse welfare loss and new failures; tax incentives targeting at supporting infant industries can prompt them into becoming monopolists in the market; export subsidies could trigger subsidy competition and the situation of racing to the bottom that everyone ends up poorer; tax incentives with the purpose of improving equity can actually be discriminatory. Therefore, it is also essential to control the use of tax incentives as subsidies.

In the context of international trade and competition, the benchmarks to evaluate tax incentives are efficiency and equity in the market, which are the starting points for conducting trading activities. In order to prevent these harmful effects, it is necessary to regulate the use of tax incentives, which should mainly be in the form of legal regulation. Furthermore, the rule of law regulation should normally entail the ex ante and ex post assessment of tax incentives. Moreover,

[203] Hancher, Ottervanger and Slot, *EU State Aids* 33; Luja, *Assessment and Recovery of Tax Incentives in the EC and the WTO : A View on State Aids, Trade Subsidies and Direct Taxation* 21.
[204] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 86-88.

considering the transnational effects of tax incentives, it is necessary to regulate the use of these incentives at an international or supranational level, with the purpose of decreasing the inefficient allocation of global economic resources and maintaining a level playing field in international trade.

Consequently, it is essential to establish systematic regulations and rules to restrict the use of tax incentives as subsidies. Internationally, the WTO and the EU respectively have developed specific regulations on subsidies, with the focus on taxation. The next chapter contains a further introduction and analysis of the rules of the two legal systems.

Chapter 3 Subsidy Rules of the WTO and State Aid Law in the EU

3.1 Introduction

Internationally, the most influential legal organization regulating subsidies is the WTO.[205] It has specific rules on the regulation of subsidies contained in the Agreement on Subsidies and Countervailing Measures (ASCM). As an international trade organization, the WTO has a main objective of trade liberalization.[206] The ASCM serves this objective but it has a more specific object and purpose on regulating subsidies.

The European Union is a unique Member in the WTO, which has a stringent internal subsidy regime.[207] A subsidy in the EU is regarded as a measure of State aid. There are many similarities between the EU State aid regime and the subsidy regime in the WTO, and therefore a comparative study from the EU State aid perspective may contribute to a better understanding of various approaches that can achieve similar objectives. In this way, a systematic study on the EU State aid law can contribute to a deeper analysis of subsidies, and especially fiscal subsidies.

In order to develop a benchmark for a further evaluation of Chinese tax incentives, it is important to connect the rationale of regulating tax incentives in the previous chapter with the objects and purposes of the two legal systems. This will contribute to finding out whether they share common objectives that can become an external benchmark for evaluation.

This chapter first analyzes the objects and purposes of the two systems and the particular objectives of the WTO's subsidy rules and EU State aid law. It subsequently develops a benchmark based on the common objects and purposes of the two legal regimes with respect to the efficiency and equity considerations established in the previous chapter. Afterwards, it introduces the WTO subsidy rules and EU State aid law respectively and compares the two legal systems to discover similarities and differences under their common objectives. The common benchmark and the introduction to the rules of the two systems are the basis for testing the compatibility of Chinese tax incentives in the following chapters.

The premise of both systems for the regulation of subsidies is the market economy, as both systems are based on the operation of market economy. According to the theory of public finance,

[205] Ibid 86-88.
[206] Van den Bossche, *The Law and Policy of the World Trade Organization : Text, Cases and Materials* 85.
[207] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 86-88.

under a market economy, the relationship between the government and the market is that the market plays a major role in resource allocation, while the role of governments shall be limited.[208]

3.2 External benchmark: based on the common object and purpose of the WTO's subsidy rules and EU State aid

3.2.1 Introduction

It is important to develop a benchmark to evaluate the following testing. As analyzed in the previous chapter, the starting points of regulating tax incentives as subsidies are the efficiency and equity considerations for the operation of the market. Therefore, the analysis of the objects and purposes of the two systems contributes to further understanding the rationale of the two systems for regulating subsidies respectively. The common objectives and purposes of the two systems can become a benchmark for the evaluation of the following testing.

3.2.2 The WTO regulation of subsidies

3.2.2.1 Object and purpose of the WTO

The WTO, considering its number of Members, is the world's most influential international legal institution that provides for trade rules.[209] Since the establishment of the WTO, the organization has dealt with the rules on trade between nations. As a result, WTO laws are constituted in a series of agreements negotiated and signed by Members.[210]

The WTO aims to create an open and non-discriminatory multilateral trading system, with an emphasis on the protection of the environment and the promotion of sustainable development.[211] The two main instruments to achieve these objectives are the reduction of tariff barriers and other barriers to trade and the elimination of discriminatory treatment in international trade relations. Additionally, the WTO endeavors to create a level playing field for all the members to conduct

[208] Musgrave and Musgrave, *Public Finance in Theory and Practice*.

[209] The WTO has 162 Members since 30 November 2015. See the WTO's official website <https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm> accessed 11 February 2016.

[210] The WTO rules are the results of negotiations between Members. The current rules are mostly the results of the Uruguay Round (1986-1994) and earlier negotiations under the General Agreement on Tariffs and Tarde (GATT). The latest rules were developed in the negotiations of the Doha Round since 2001. See the WTO's official website <https://www.wto.org/english/thewto_e/whatis_e/who_we_are_e.htm> accessed 11 February 2016.

[211] Van den Bossche, *The Law and Policy of the World Trade Organization : Text, Cases and Materials* 85.

trade and international business.[212] Therefore, the regulation of subsidies worldwide fits exactly within the objectives of the WTO.

3.2.2.2 Historical development of subsidy rules in the WTO

A subsidy in the WTO framework is regarded as a distortion of international trade.[213] The major agreement in the WTO disciplining subsidies is the Agreement on Subsidies and Countervailing Measures of 1994 (the ASCM).[214] It contains an internationally agreed definition of the term subsidy and the standard for the classification of subsidies. This agreement resulted from the negotiations of the Uruguay Round (1986 to 1994) in 1994 and became the universally applicable benchmark for subsidies and countervailing measures.[215]

However, the process to reach an agreement on the ASCM was rather complex. As early as in 1947, the predecessor of the WTO, the General Agreement on Tariffs and Trade (GATT) recognized that subsidies and countervailing measures could constitute non-tariff barriers to trade. Therefore, the GATT 1947 set out rules on the use of subsidies and countervailing measures.[216] Nevertheless, the negotiations did not achieve a consensus on the definition of a subsidy, thereby resulting in the limited effectiveness of the rules.[217] In order to address the increasing trade disputes in the area of subsidies, the GATT Subsidies Code was concluded in 1979 during the

[212] The WTO's main activities are negotiating the reduction or elimination of obstacles to trade (import tariffs, other barriers to trade) and agreeing on rules governing the conduct of international trade (e.g. antidumping, subsidies, product standards, etc.); administering and monitoring the application of the WTO's agreed rules for trade in goods, trade in services, and trade-related intellectual property rights; settling disputes among Members regarding the interpretation and application of the agreements, etc. See the WTO's official website, About the WTO <https://www.wto.org/english/thewto_e/whatis_e/wto_dg_stat_e.htm> accessed 11 February 2016.

[213] Warren F. Schwartz and Eugene W. Harper, 'The Regulation of Subsidies Affecting International Trade' (1972) Michigan law review 831, 831-833.

[214] The Agreement on Subsidies and Countervailing Measures (the ASCM). See https://www.wto.org/english/docs_e/legal_e/24-scm.pdf.

[215] Coppens, *WTO Disciplines on Subsidies and Countervailing Measures* 30-35.

[216] Article VI (3), Article VI (4); Article VI (5); Article VI (6) of the GATT provide rules on the use of subsidies and anti-dumping duties, see Article VI of the GATT 1947. See https://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf.

[217] Peggy A. Clarke and Gary N. Horlick, 'The Agreement on Subsidies and Countervailing Measures' in Authur Appleton Patrick Macrory, Michael Plummer (ed), *The World Trade Organization: Legal, Economic and Political Analysis*, vol II (The World Trade Organization: Legal, Economic and Political Analysis, Springer 2005) 681-682.

Tokyo Round negotiations.[218] The Code included two tracks: the first track introduced a procedure to adopt countervailing duties, while the second track focused on regulating the use of subsidies and government's obligations in relation to the use of subsidies.[219] However, due to the lack of a concrete definition of subsidies, not many countries singed the Code,[220] which limited its validity. Concerning the failure of the Subsidies Code to achieve trade liberalization, later a new round of negotiations were undertaken, the Uruguay Round, which aimed at counteracting subsidies and the abuse of countervailing measures. Consequently, in 1994, Members agreed to adopting the ASCM as the main body of rules regulating subsidies. In 1995, the WTO was established, substituting the GATT. The ASCM also became an essential part of WTO law.[221]

Nevertheless, the ASCM only disciplines subsidies for goods but not for services. Subsidies for services are regulated under the General Agreement on Trade in Services (GATS), which addresses the liberalization of trade in services.[222]

Compared to the regulation of subsidies for goods, the regulation of subsidies for services in the WTO regime is not very strict, because there is no clear definition of subsidies for services and no precise remedy for the adverse effects of service subsidies. It only mentions that a future work program shall be determined according to multilateral negotiations,[223] which implies that the GATS has not yet developed a complete legal framework for subsidies for services. Therefore, for Members of the WTO, there is little guidance for determining their activities or solving trade disputes on services.[224] However, this does not mean that subsidies for services are not as important as subsidies for goods. Actually, they do not differ with respect to their distorting effects

[218] Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, BISD, 26th Supp. 56 (1980) (1979 Subsidies Code). See https://www.wto.org/english/docs_e/legal_e/tokyo_scm_e.pdf.
[219] Clarke and Horlick, 'The Agreement on Subsidies and Countervailing Measures' 684.
[220] Only 24 contracting parties signed the agreement.
[221] Coppens, *WTO Disciplines on Subsidies and Countervailing Measures* 35-38.
[222] The GATS was one of the landmark achievements of the Uruguay Round, the results of which entered into force in January 1995. It shares similar objectives as the GATT: creating a credible and reliable system of international trade rules; ensuring fair and equitable treatment of all participants; stimulating economic activity through guaranteed policy bindings; and promoting trade and development through progressive liberalization. See Preamble of the GATS, https://www.wto.org/english/docs_e/legal_e/26-gats.pdf.
[223] Footnote 7 of the GATS: a future work program shall determine how, and in what time-frame, negotiations on such multilateral disciplines will be conducted.
[224] Wolfrum and Stoll, *WTO : Trade Remedies* 352.

to trade. Although there are discussions on transplanting the definition of a subsidy from the ASCM to the GATS, no substantial progress has been made in this respect.[225]

Therefore, only in the testing part, the research focuses on subsidies for goods and the relative regulations in the ASCM, because, to conduct testing, it is necessary to have relatively clear criteria to identify subsidies. However, when analyzing tax incentives in general, the research analyzes subsidies both for goods and services.

3.2.2.3 Object and purpose of the ASCM

Although the ASCM does not explicitly stipulate its object and purpose, in many cases settled by the Dispute Settlement Body (DSB) of the WTO,[226] the Panel or the Appellate Body explained the object and purpose of the Agreement in the context of the WTO's general object and purpose.

In the case of Brazil-Aircraft, [227] the Panel considered that the object and purpose of the ASCM is to impose multilateral disciplines regulating subsidies that distort international trade.[228] In the case of Canada-Aircraft,[229] the Panel stated that the object and purpose of the ASCM could appropriately be summarized *"as the establishment of multilateral disciplines 'on the premise that some forms of government intervention distort international trade, or have the potential to distort international trade'".*[230] In US-Export Restraints,[231] the Panel emphasized again that the ASCM aimed at regulating distortions caused by governmental subsidies.[232]

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[225] Ibid 353.

[226] The Dispute Settlement Body (the DSB), consisting of all WTO Members, settles disputes in the WTO. The DSB has the authority to establish "panels" of experts to consider the case, and to accept or reject the panels' findings or the results of the appeal. Normally, the panel's report becomes the DSB's ruling or recommendation to the parties of the case. Each party to the dispute can appeal a panel's ruling. The appeal is handled by the Appellate Body set up by the DSB and broadly represents the range of WTO membership. Trebilcock, Howse and Eliason, *The Regulation of International Trade* 51-53.

[227] WT/DS46/R, Brazil-Aircraft, 14 April 1999.

[228] WT/DS46/R, Brazil-Aircraft, 14 April 1999, Panel Report, at para. 7.26. The Panel held that "in our view, the object and purpose of the ASCM is to impose multilateral disciplines on subsidies which distort international trade. It is for this reason that the ASCM prohibits two categories of subsidies---subsidies contingent upon exportation and upon the use of domestic over imported goods---that are specifically designed to affect trade".

[229] WT/DS70/R, Canada-Aircraft, 14 April 1999, Panel Report.

[230] Ibid at para. 9.119.

[231] WT/DS194/R, US-Exports Restraints, 29 June 2001, Panel Report.

[232] Ibid at para. 8.63.

From the Panels' statements in various cases, it is clear that the ASCM constitutes an essential part of the WTO law disciplining subsidies that distort international trade. Accordingly, it serves the objective of creating a level playing field for participants in international trade.

3.2.2.4 The WTO's regulation of tax subsidies

The main object and purpose of the WTO is the liberalization of trade, resulting in the creation and maintenance of a level playing field for free trade. With respect to taxation, each Member fully enjoys sovereignty over its own tax regime. Only when a Member's tax measures constitute trade barriers, and breach the WTO's rules, the WTO will function as a regulator or adjudicator for those incompatible tax measures.[233] The WTO has also developed rules to counteract subsidies in the form of tax incentives.[234] However, the WTO *per se*, is not a specific international organization established to tackle complicated tax issues, such as tax competition or tax treaties.[235]

3.2.3 The European Union's regulation of State aid

3.2.3.1 Object and Purpose of the European Union

The object of the European Union is described in Article 3 (3) of the Treaty on European Union: "the Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological

[233] WT/DS108/R, US-FSC, Panel Report, 8 October 1999; WT/DS108/AR/RW, US-FSC-Recourse to Article 21.5 of the Dispute Settlement Understanding (DSU) by the EC, Appellate Body Report, 14 January 2002; WT/DS108/AB/RW2, US-FSC, Second Recourse to Article 21.5 of the DSU by the EC, Appellate Body Report, 13 February 2006. Carmichael, 'Foreign Sales Corporations-Subsidies, Sanctions, and Trade Wars'; Clark, Bogran and Hanson, 'The WTO Ruling on Foreign Sales Corporations : Costliest Battle Yet in An Escalating Trade War between the United States and the European Union?', 310.

[234] In Annex I of the ASCM, there is an illustrative list of export subsidies in the form of direct and indirect taxes. Section 3.3.4 has more discussion on this issue.

[235] Jennifer E. Farrell, 'The Interface of International Trade Law and Taxation : Defining the Role of the WTO', IBFD 2013) 223-225; Asf H. Qureshi, 'Trade-Related Aspects of International Taxation -- A New WTO Code of Conduct?' (1996) 30 Journal of World Trade 164; Adrian J. Sawyer, Lillian Mills and Lisa Stripling, 'Developing a World Tax Organization: The Way Forward' (2010) 32 The Journal of the American Taxation Association 58-60; Turki Althunayan, *Dealing with the Fragmented International Legal Environment-WTO, International Tax and Internal Tax Regulations* (Springer 2010) 71-93; Reuven S. Avi-Yonah, 'Treating Tax Issues Through Trade Regimes' (2001) Brooklyn Journal of International Law 1689-1690; Joel Slemrod and Reuven Avi-Yonah, '(How) Should Trade Agreement Deal With Income Tax Issues?' (2002) 55 Tax Law Review 552-554.

advance."[236] Also according to Article 26 of the TFEU, "the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties."[237]

The establishment of an internal market is the ultimate objective of the EU with respect to economic activities. The intention of creating the internal market is that a market based economy, open to free trade, can best guarantee the welfare of the EU.[238] Thus, basic economic theories of a market economy apply to the EU internal market. In order to increase efficiency and equity in the market, it is important to create a fair competition environment for participants in such a market. Therefore, EU law prohibits Member States' actions that distort competition in the market.

3.2.3.2 Historical development of EU State aid law

State aid control was first introduced in the Treaty establishing the European Economic Community (the EEC Treaty) in 1957 as one of the strategies to strengthen Europe's position in the world.[239] Although the Treaty established principles on the prohibition of State aid, the concept of State aid in this Treaty was not precise enough for Member States to implement specific actions. During the 1970s and 1980s, State aid provisions experienced a standstill period because of the economic crisis.[240] In this period, Member States competed to use subsidies to stimulate the economy, but the Community was not capable of controlling the abuse of subsidies by Members. From the late 1980s, the regulation of State aid gained the Community's attention again, since governments were willing to overcome the problem cooperatively because more industries and

[236] The Treaty of European Union [2012] OJ C326/13. See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012M/TXT&from=EN.
[237] The Treaty on the Functioning of the European Union (TFEU) [2012] OJ C326/47. See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN.
[238] Anna Jarosz-Friis and Tibor Scharf, 'External Aspects of State Aid Policy' in Mederer Wolfgang and Brice Allibert (eds), *EU Competition Law*, vol 4 (EU Competition Law, Claeys & Casteels 2008) 124. See also Article 119 of the TFEU. It reemphasized that Member States should act in accordance with the principle of an open market economy with free competition.
[239] The Treaty Establishing the European Community [1992] OJ C224/6 (the EEC Treaty). Article 2 of the Treaty states that the European Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the states belonging to it. See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11992E/TXT&from=EN.
[240] Wolfgang Allibert B. Mederer, *EU Competition Law. Vol. 4* (Claeys & Casteels 2008) 23.

sectors were open for competition, thereby requiring a unified regulation of State aid.[241] Since then, State aid law started to develop into a system in the context of the establishment of a single market.

In the 21st century, State aid control entered into a process of modernization. It started with the introduction of the State Aid Action Plan (SAAP)[242] from 2005 to 2009, aiming at improving enforcement by introducing an effect-based approach to identifying State aid. Moreover, with the implementation of the TFEU in 2009, State aid was defined comprehensively in the Treaty. In 2012, the European Commission set out a new reform program on State aid modernization (SAM) with more ambitious objectives, i.e. to foster growth in a strengthened, dynamic and competitive internal market; focus enforcement in cases with the biggest impact on the internal market; streamlined rules and faster decisions.[243] With these objectives, State aid law is developing extensively.

3.2.3.3 Object and purpose of EU State aid law

As a part of EU law, State aid law shares the same object and purpose of the EU at the macro level, aiming at creating and safeguarding an internal market. In order to realize the aim of an internal market, distortion of competition is forbidden, since, if certain economic participants are favored unfairly by State aid measures, the level playing field may become at risk.[244] Therefore, State aid law, as a part of EU competition law, is designed to limit the negative effects of State aid and to create a level playing field for all Member States. It delivers both the integration and the prosperity objective through ensuring open markets and competition on merits.[245]

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[241] Ibid.

[242] State Aid Action Plan: Less and Better Targeted State Aid: A Roadmap for State Aid Reform 2005-2009 [2005] COM (2005) 107 final, see http://ec.europa.eu/competition/state_aid/reform/saap_en.pdf.

[243] EU State Aid Modernization (SAM) [2012] COM (2012) 209 final, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0209&from=EN; European Commission-Press Release, State aid: Commission turns state aid modernization into action and calls for better cooperation with Member States to boost growth (18 December 2014) <http://europa.eu/rapid/press-release_IP-14-2783_en.htm> accessed 15 February 2016.

[244] Nicola Pesaresi and Marc van Hoof, 'State Aid Control: An Introduction' in Wolfgang Mederer, Nocola Pesaresi and Marc van Hoof (eds), *EU Competition Law-State Aid* (EU Competition Law-State Aid, Claeys & Sasteels 2008) 3.

[245] European Parliament resolution of 19 June 2007 on the Report on Competition Policy 2005 (2007/2078(INI)), at para. 31, see http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2007-0263+0+DOC+XML+V0//EN.

3.2.3.4 The EU State aid's regulation of tax aid

With respect to taxation, State aid law plays an increasingly important role in restricting the harmful effects of taxation in the internal market. In 1997, the European Commission adopted a code of conduct for business taxation (Code of Conduct) aiming at improving transparency in the tax area through the exchange of information.[246] Subsequently, in 1998, the Commission introduced a notice on the application of State aid rules to measures relating to direct business taxation (the 1998 Notice)[247] and a report on the implementation of the notice in 2004.[248] The European Commission has systematically applied State aid law to the regulation of tax incentives.[249] With the further development of State aid law under the SAAP and the program on SAM, the application of State aid rules to taxation is also evolving as well. The trend in the EU is to strengthen the functionality of the State aid rules in relation to taxation.[250] In 2016, the European Commission published a Notice, which explains how to identify tax rulings and tax settlements as

[246] Code of Conduct, Council conclusions of the ECOFIN council meeting on 1 December 1997 concerning taxation policy [1998] OJ C2/1, see http://ec.europa.eu/taxation_customs/resources/documents/coc_en.pdf.
[247] Commission Notice on the application of the State aid rules to measures relating to direct business taxation [1998] OJ C384/3 (the 1998 Notice), see http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1998:384:0003:0009:EN:PDF.
[248] Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation [2004] C (2004) 434, see http://ec.europa.eu/competition/state_aid/studies_reports/rapportaidesfiscales_en.pdf.
[249] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 9.
[250] Wolfgang Schön, *Tax Legislation and the Notion of Fiscal Aid-A Review of Five Years of European Jurisprudence* (The Max Planck Institute for Tax Law and Public Finance 2015), available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2707049. See also European Commission-Press release, State Aid: Commission Concludes Belgian "Excess Profit" Tax Scheme Illegal; Around 700 Million Euros to be Recovered from 35 Multinational Companies (11 January 2016), <http://europa.eu/rapid/press-release_IP-16-42_en.htm> accessed 18 January 2016; European Commission-Press release, Commission Opens Formal Investigation into Luxembourg's Tax Treatment of McDonald's (3 December 2015) <http://europa.eu/rapid/press-release_IP-15-6221_en.htm> accessed 18 January 2016; European Commission-Press release, Commission Decides Selective Tax Advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU State Aid Rules (21 October 2015) <http://europa.eu/rapid/press-release_IP-15-5880_en.htm> accessed 18 January 2016； President Juncker, Commissioner Moscovici and Commissioner Vestager address the EP's Special Committee on Tax Rulings, 17 September 2015. See European Commission State Aid Weekly e-News, No. 30/15, 17/09/2015, http://ec.europa.eu/competition/state_aid/newsletter/17092015.pdf.

State aid.[251] Therefore, State aid law plays an increasingly important role in combating harmful tax competition in the EU.[252]

3.2.4 External benchmark: the creation of a level playing field based on the common object and purpose of the WTO and the EU

3.2.4.1 Efficiency considerations

From an economic perspective, the premise of both systems regulating subsidies in the EU and under the WTO is the market economy. In order to increase efficiency in the market, it is necessary to control governmental intervention into the market. The two systems regulate governmental action through their laws. Both systems aim to regulate the adverse effects caused by subsidies in order to provide a level playing field for other unsubsidized economic participants in the market. "The underlying basis of both systems is that the benefits of liberalized markets arising from increased economic efficiency should not be neutralized by government interventions."[253] Thus, the efficiency consideration is significant in the control of the use of subsidies by governments.

3.2.4.2 Equity considerations

Both the EU and the WTO emphasize the creation of a level playing field for competition, which is the embodiment of equity considerations. As explained in last chapter, the rule of law here is considered to contribute to equity between producers in competition and it has also the purpose of realizing distributive equity between producers and consumers.[254] When applying this rationale to the common object and purpose of the two legal systems, it is obvious that a level playing field firstly aims to ensure equity between competitors or producers. No country can offer specific preferential subsidies to certain enterprises or regions to gain an advantageous position compared to other enterprises or regions. There should be an equal starting point for each participant in the market. Therefore, the two systems share a common goal of maintaining a level playing field for members in the international market. In addition, the laws should also ensure distributive equity, namely, equity between producers and consumers when the market fails to achieve it. Although it

[251] On 19 May 2016, the European Commission published a Notice on the notion of State aid as referred to in Article 107 (1) TFEU. It explains how to identify tax rulings and tax settlements as State aid. See Section 5.4, Commission Notice on the Notion of State Aid as Referred to in Article 107 (1) TFEU. See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016XC0719(05)&from=EN. See Section 1.1.3 in Chapter 1.

[252] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 40-42.

[253] Ben Slocock, 'EC and WTO Subsidy Control Systems : Some Reflections' (2007) European State Aid Law Quarterly 250.

[254] See Section 2.2.1.1 in Chapter 2.

is the aim of the two systems to regulate the behavior of governments, it does not deny the possibility for governments to correct market failures. By using tax incentives as subsidies, governments could realize the objective of distributive fairness. Hence, the two legal systems should inherently embed in the regulation the common goal of distributive equity, which is an essential element in order to increase social welfare.

However, the notion of fairness is still ambiguous.[255] "It is inherently subjective and is internationally nuanced and culturally distinctive."[256] According to the theories of legal jurisprudence, there are two types of fairness, formal and substantive.[257] An illustration of formal fairness is Aristotle's notion of formal justice, i.e. equals are to be treated equally and those that are unequal are to be treated unequally.[258] However, this is a general principle that does not specify further detail in order to make substantive distinctions between these two categories. Thus, some authors contend that a fair outcome cannot be reached without a fair process, and therefore they advocate a procedural theory of fairness that can lead to justice.[259] According to Rawls, there are two basic principles of fairness. First, everyone will have an equal right to the most extensive basic liberties compatible with similar liberty for others; second, social and economic inequalities must satisfy two conditions: they are attached to positions open to all under conditions of fair equality of opportunity and they are to the greatest benefit of the least advantaged.[260] Nevertheless, the Rawls criterion of fairness does not necessarily mean that it will lead to the optimal welfare and it can even contradict the usual economic criterion.[261] It seems that procedural justice is a necessary but not a sufficient condition for substantive fairness.[262]

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[255] Thomas Martin Franck, *Fairness in International Law and Institutions* (Clarendon Press 1995) 49; Carl Davidson, Steve Matusz and Doug Nelson, 'Fairness and the Political Economy of Trade' (2006) 29 World Economy ; Sobel, 'Welfare Economics and Public Finance' 24-25; Allan M. Feldman and Roberto Serrano, 'Fairness and the Rawls Criterion' in Allan M. Feldman and Roberto Serrano (eds), *Welfare Eocnomics and Social Choice Theory* (Welfare Eocnomics and Social Choice Theory, Springer 2006) 217-225.
[256] Taylor, *International Competition Law : A New Dimension for the WTO?* 26.
[257] Louis Pojman and Robert Westmoreland, *Equality : Selected Readings* (Oxford University Press 1997) 2-4.
[258] Ibid.
[259] This theory was advocated by John Rawls and Robert Nozick. See Rawls, *A Theory of Justice*; Robert Nozick, *Anarchy, State and Utopia* (Basil Blackwell 1974).
[260] Rawls, *A Theory of Justice* 4.
[261] Feldman and Serrano, 'Fairness and the Rawls Criterion' 224-225; Kaplow and Shavell, *Fairness versus Welfare* 69-81.
[262] Bert Van Roermund, 'Fairness', *The Encyclopedia of Political Thought* (The Encyclopedia of Political Thought, John Wiley & Sons, Ltd 2014).

When discussing the two legal systems' role in achieving distributive fairness, the focus should still be on the control of governmental behaviors, but it raises further questions such as the degree and criteria of that control. Referring to the basic theory of public finance, perhaps the principle of proportionality can shed light on the interpretation of fairness here. To be more specific, the intervention by the government shall be examined against the principle of proportionality, according to which two conditions have to be met: there is a legitimate goal of the government policy; and there is a reasonable proportionality between the means used and the intended goal.[263]

3.2.5 Conclusion

In conclusion, by creating and maintaining a level playing field for competitors in the international market, the common objects and purposes of the WTO's subsidy rules and EU State aid law can become a common benchmark for assessing Chinese tax incentives. The common benchmark actually reflects the efficiency and equity rationale of regulating subsidies, as analyzed in the previous chapter. The laws are legal regulations addressing governmental intervention into the market. The rationale for such laws is the desire to increase market efficiency. On the other hand, the laws embody the values of equity, including equity between competitors and equity for distributive purposes. The principle of proportionality actually can become a standard to interpret fairness that guides governments' actions.

3.3 Overview of the Agreement on Subsidies and Countervailing Measures (the ASCM)

This Section follows Chart 1 to introduce the ASCM and its application to taxation.

[263] Hans Gribnau, 'General Introduction' in G.T.K. Meussen (ed), *The Principle of Equality in European Taxation* (The Principle of Equality in European Taxation, Kluwer Law International 1999) 31-32.

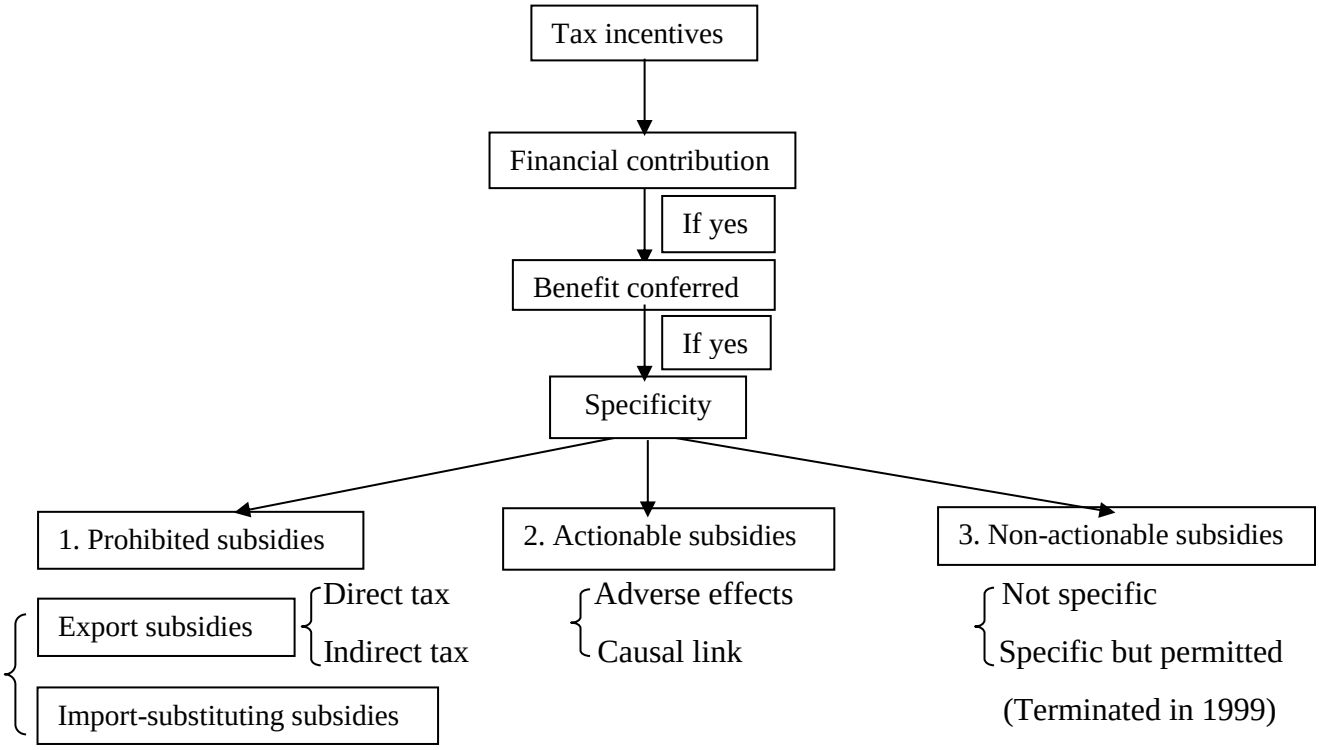

Chart 1

3.3.1 Definition of subsidies

Article 1.1 of the ASCM defines a subsidy as follows: (a) a financial contribution made by a government or any public body which (b) confers a benefit that (c) is specific within the meaning of Article 2 of the ASCM.

3.3.1.1 Financial Contributions

The first element to identify a subsidy refers to "a financial contribution by a government or any public body within the territory of a Member". According to this definition, it seems that the ASCM targets governmental actions of WTO Members, and therefore the actions of private entities are not likely to be inconsistent with the ASCM. However, if private entities are controlled or directed by the government and engage in actions which constitute financial contributions to the recipient, these private entities can also fall within the notion of "government or any public body" within the meaning of the definition.[264]

Article 1.1(a) (1) also illustrates different forms that a contribution can take:

[264] Madrid, 'Preliminary Remarks and Economic Analysis of Subsidies' 104.

i) a government practice involves a direct transfer of funds, potential direct transfers of funds or liabilities;

ii) government revenue that is otherwise due is foregone or not collected;

iii) a government provides goods or services other than general infrastructure, or purchases goods;

iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

Tax incentives result in government revenue that is otherwise due, is foregone or not collected. Although Article 1.1(a) (1) does not provide an explanation as to what constitutes government revenue, it can be regarded as any compensation that the state receives by exercising their governmental faculties, such as taxes, duties, and social welfare charges.[265]

With regard to the phrase "that is otherwise due is foregone or not collected", it is important to compare the situation caused by the government measure with the situation that would have occurred but for the measure foregoing the revenue by the government. The Appellate Body in the US-FSC case[266] pointed out that the "foregoing" of revenue "otherwise due" implied that less revenue had been raised by the government than would have been raised in a different situation or that was raised "otherwise". The word "foregone" suggests that the government had given up an entitlement to raise revenue that it could "otherwise" have raised. If a certain condition led to a greater decrease in government revenue than the same situation without this condition, whether

[265] WT/DS108/R, US-FSC, 8 October 1999, Panel Report, at para.7.102 and WT/DS139/R and WT/DS142/R, Canada-Autos,11 February 2000, Panel Report, at para.10.160. However, this contribution does not include the exemption of an exported product from duties or tax borne by such a product when destined for domestic consumption. Interpretive Note 1 to the ASCM establishes that: "in accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

[266] WT/DS108/AB/R, US-FSC, 24 February 2000, Appellate Body Report.

the change of this certain condition was through tax policy or otherwise due, the financial contribution would be deemed to exist.[267]

Therefore, it is necessary to analyze whether the government measure impedes the collection of revenue that would have been collected otherwise, and the analysis shall be carried out on a case-by-case basis.

3.3.1.2 Benefit conferred

Pursuant to Article 1.1 (b) of the ASCM, a benefit can be regarded as the financial contribution made by the government or income or price support conferred on a recipient. However, the term "benefit" is not defined in the ASCM itself.

The Panel in the Canada-Aircraft case[268] stated that the ordinary meaning of "benefit" clearly encompassed some form of advantage. In order to determine whether a financial contribution confers a "benefit", it was necessary to determine whether the financial contribution placed the recipient in a more advantageous position than it would have been otherwise.[269] Therefore, to prove the existence of a benefit, a comparison must be undertaken between the benefits received from the government and the benefits that would have been obtained under normal market conditions.[270] In the case of US-Lead and Bismuth II,[271] the Appellate Body stated: "the question whether a 'financial contribution' confers a 'benefit' depends, therefore, on whether the recipient has received a 'financial contribution' on terms more favorable than those available to the recipient in the market".[272]

3.3.1.3 Specificity

Specificity refers to the question of whether a subsidy is generally available for all industries within the region to which the government grants assistance or whether, on the contrary, such a subsidy is only granted to an enterprise or industry or group of enterprises or industries.

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[267] Ibid at para. 90.
[268] WT/DS70, Canada-Aircraft, 14 April 1999, Panel Report.
[269] Ibid at para. 9.112-9.113.
[270] The same interpretation of the term "benefit" can be found in other disputes. See WT/DS139/AB/R and WT/DS142/AB/R, Canada-Autos, 11 February 2000, Panel Report, at para.10.165; WT/DS46/AB/R, Brazil-Aircraft, 2 August 1999, The Appellate Body Report, at para. 165-187; WT/DS138/AB/R, US-CVDs on EC Steel Products, 6 July 1998, at para.68.
[271] WT/DS138, US-Lead and Bismuth II, 10 May 2000, Appellate Body Report.
[272] Ibid at para. 157.

(1) Subsidies limited to certain enterprises

Article 2 of the ASCM stipulates the criteria for determining the specificity of subsidies. There are two general categories of specificity.

De jure specificity: where access to a subsidy is explicitly limited to certain enterprises (or groups or enterprises, or industries, etc.) by the granting authority, or the legislation pursuant to which it operates.[273]

De facto specificity: a subsidy may be considered to be specific even in the absence of an explicit limitation to certain enterprises or the presence and adherence to objective criteria or conditions. If there are reasons to believe that a subsidy may in fact be specific, other factors will be considered, such as: the use of a subsidy programme by a limited number of certain enterprises; the predominant use by certain enterprises; the granting of disproportionately large amounts of subsidy to certain enterprises; and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy.[274]

(2) Regional subsidies

Article 2.2 of the ASCM discusses the specificity of subsidies limited to certain enterprises located within a designated geographical region within the granting authority's jurisdiction. However, it is still difficult to identify regional specificity based on this provision. There are two conflicting interpretations of the provision. One holds that the wording "limited to certain enterprises" suggests that subsidies destined to all enterprises in a geographical region are not considered specific.[275] The other takes an opposite approach that regardless of the fact that the

[273] Article 2.1 (a) of the ASCM. Article 2.1(b) of the ASCM stipulates that specificity does not exist where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions defined as criteria or conditions which are neutral, which do not favor certain enterprises over others, and which are economic in nature and horizontal in application, such as the number of employees or the size of the enterprise governing the eligibility for, and the amount of, a subsidy and provided that eligibility is automatic and that such criteria and conditions are strictly adhered to. In addition, the criteria or conditions must be clearly spelled out in the law, regulation, or other official document, so as to be capable of being verified.

[274] Article 2.1(c) of the ASCM. The Panel in Lumber IV case held that the determination of specificity did not need to be based on an examination of all four of these factors listed above, but could be based on only some. See WT/DS257/R, US-Softwood Lumber IV, 29 August 2003, Panel Report, at para.7.123.

[275] Claus-Dieter Ehlerman and Martin Goyette, 'Interface between EU State Aid Control and the WTO Disciplines on Subsidies' (2006) 4 European State Aid Law Quarterly 702, footnote 50. The author explained that the earlier draft of this Article used the wording that "a subsidy which is available to *all* enterprises located within a designated geographical region". Nevertheless, the present Article adopted the wording of "certain enterprises" instead of "all enterprises", thus revealing a distinction between the two.

subsidy is granted to all undertakings or certain undertakings, if it is only confined to a designated region it is specific.[276]

When reading the Article, the wording "within the granting authority's jurisdiction" contributes to the understanding of specificity. According to Wolfrum, Stoll, and Koebele (2008), there is a distinction between subsidies granted by the central government and by the sub-central or regional government. [277] If the subsidy is granted by the central government, "the granting authority's jurisdiction" is the country's overall territory, and therefore the limitation to a designated region is specific regardless of whether the beneficiaries are all enterprises or certain enterprises in that region. Nevertheless, if the subsidy is provided by a regional government within the jurisdiction of that region, only when the subsidy is limited to certain enterprises will it be considered to be specific. On the contrary, subsidies available to all enterprises should not be regarded as specific. In the situation that both the central and regional government have participated in the granting of a regional subsidy, "such subsidy should be regarded as being granted by the central authority if it is established that the subsidy would not have taken place in the absence of the central authority".[278] Therefore, a regional subsidy is specific even if it is granted to all enterprises within the region.

This interpretation is more convincing than the two conflicting views mentioned earlier, because it goes back to the wording of the Article itself and distinguishes between scenarios based on the granting authority. Indeed, it cannot simply rely on the criteria of the subsidy being granted to "all" or "certain" enterprises to make a judgment on of the specificity of the regional subsidy. After all, the regional characteristic is the defining characteristic of this category.

The second sentence of this Article addresses the special case of subsidies granted through fiscal measures. According to this sentence, "the setting or change of generally applicable tax rates by

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Therefore, the author believed that only subsidies limited to certain enterprises in a region are specific, but those available to all enterprises in a region are non-specific. This view is also confirmed by Luengo. See Madrid, 'Preliminary Remarks and Economic Analysis of Subsidies', 139-140.

[276] Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective*, 370-371. The argument is that regional subsidies distort resource allocation between regions, and therefore even subsidies that are granted to all enterprises in the region, compared to other regions, results in this region having an advantage over others.

[277] Wolfrum and Stoll, *WTO : Trade Remedies* 460-461, 467-468.

[278] Ibid 461.

all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this Agreement". Thus, different tax rates of different provinces and autonomous regions, with authority, are therefore "non-specific". In other words, regional tax incentives granted by the regional government not available to all enterprises are specific.[279]

(3) Prohibited subsidies

Subsidies covered by Article 3 of the ASCM are also specific. Article 3 contains two types of prohibited subsidies, i.e. export subsidies and import substitution subsidies.[280] Since these types of subsidies are considered to be more harmful to international trade, to ensure that they do not escape from the application ASCM, once they fulfill the requirements to be considered prohibited subsidies, they are automatically deemed to be specific.[281]

3.3.2 Classification of subsidies

There are two types of subsidies in the ASCM: prohibited subsidies and actionable subsidies.[282] Prohibited subsidies are absolutely prohibited by the ASCM since they can cause a serious distortion to international trade. However, actionable subsidies are subject to the Agreement only because they have negative effects on trade. The criterion for considering specific subsidies as falling into the category of actionable subsidies is that they cause adverse effects to the interests of other Members.[283]

3.3.2.1 Prohibited subsidies

(1) Export Subsidies

Subsidies contingent in law or in fact upon export performance are prohibited in the ASCM.[284] In order to clearly define concrete measures that constitute export subsidies, an illustrative list is attached in Annex I of the ASCM to identify measures that are considered export subsidies.[285]

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[279] Ibid 468.
[280] The next section contains a further introduction to the classification of subsidies.
[281] William A. Kerr and others, *Handbook on International Trade Policy* (Edward Elgar 2007) 302-308.
[282] Article 3 and Article 5 of the ASCM respectively addresses prohibited subsidies and actionable subsidies. There was a third category of subsidies, i.e. non-actionable subsidies. Subsidies for research and development, environmental protection, and regional development can be categorized as non-actionable subsidies. However, due to the failure of agreement on the extension of this category, it expired in 1999. See Article 8 of the ASCM. The latter sections introduce more on non-actionable subsidies.
[283] Article 5 of the ASCM.
[284] Article 3.1 of the ASCM.
[285] Annex I of the ASCM, Illustrative list of export subsidies. The list gives examples of export subsidies, such as rebates of taxes paid on the export of products and special tax treatment of income earned through export sales.

This list not only provides examples of export subsidies, but it also includes further interpretations for defining prohibited subsidies. Furthermore, to prevent disguised export subsidies granted by members, a distinction is made between *de jure* and *de facto* subsidies.

(2) Import-substituting Subsidies

Import-substituting subsidies aim at reducing imports of products from other countries, thereby favoring domestic production. However, it is not clear whether import-substituting subsidies can also be *de facto* inconsistent subsidies or not.[286] Article III of the GATT 1994 also addresses measures that favor the use of domestic over imported goods, albeit with different legal terms and with a different scope.[287] Because Article III of the GATT can apply to measures that require the use of domestic goods over imports and it covers both *de jure* and *de facto* inconsistency, and therefore this Article can be used as the context for interpreting Article 3.1 (b), which concerns the same situation. Therefore, import-substituting subsidies in Article 3.1 (b) may also be extended to subsidies contingent "in fact" upon the use of domestic over imported goods.[288]

3.3.2.2 Actionable subsidies

The second type of subsidies is actionable subsidies, which are defined by their effects: a subsidy is actionable when it causes adverse effects to another Member's interests. To determine whether a subsidy is actionable requires an examination whether there is: (1) injury to the domestic industry of another Member; (2) nullification or impairment of benefits accruing directly or indirectly to other Members under the GATT 1994, in particular the benefits of concessions bound under Article II of the GATT1994; (3) serious prejudice to the interests of another Member.[289]

3.3.2.3 Non-actionable subsidies

Except for prohibited subsidies and actionable subsidies, Article 8 of the ASCM introduces the category of non-actionable subsidies. They include subsidies that are not specific and subsidies that are specific but can be exempted from being considered actionable subsidies. This kind of

[286] The Appellate Body in the Canada-Autos case held that the fact that the words "in law or in fact" are stated in Article 3.1 (a) but were absent from Article 3.1 (b) did not necessarily mean that Article 3.1 (b) extended only to de jure contingency. Other contextual aspects should also be examined. See WT/DS139/AB/R, Canada-Autos, 31 May 2000, the Appellate Body Report, at para. 139-143.
[287] In particular, Article III (4) of the GATT states that: "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use…".
[288] WT/DS139/AB/R, 31 May 2000, Canada-Autos, the Appellate Body Report, at para. 139-143.
[289] Article 5 of the ASCM lists forms of adverse effects.

subsidy can be categorized as being either for assistance for R&D activities, assistance to disadvantaged regions, or assistance for adapting infrastructures to new environmental requirements. The ASCM initially set very strict conditions for a measure to be identified as non-actionable subsidies.[290]

However, the category of non-actionable subsidies does not exist any longer, because they were initially included for a five-year provisional period but, without an agreement on extending the application of this category, non-actionable subsidies ceased to exist as of 1 January 2000.[291] Therefore, the previous non-actionable subsidies, such as subsidies to R&D activities, for disadvantaged regions, and for adaptation of existing facilities to new environmental requirements, have become actionable currently and are deemed to have potential adverse effects to other members unless the Article will be reinstated in the future.

3.3.3 Remedies

In order to control the use of subsidies and eliminate the adverse effects caused by subsidies, the ASCM has introduced remedies for subsidy measures. Because of the different types of subsidies, diverse remedies have been designed accordingly.[292] In general, for prohibited and actionable subsidies, the DSB of the WTO normally recommends that the subsidizing Member(s) withdraw the subsidies without delay, otherwise, the complaining Member(s) can take countervailing measures towards the subsidizing Member(s).

Therefore, there are (currently) two types of remedies at both the international and domestic levels. At the DSB level, for prohibited subsidies, the subsidizing Member should withdraw the subsidy without delay; for actionable subsidies, the subsidizing Member should remove the adverse effects or withdraw the subsidies without delay; for non-actionable subsidies, the subsidizing Member could remove the serious effects. As to remedies at the Members' domestic level, with the authorization of the DSB or the Committee, Members could take appropriate countermeasures commensurate with the nature and degree of the effects determined to exist.

[290] Article 8 of the ASCM.
[291] Article 31 of the ASCM.
[292] Article 4, Article 7, and Article 9 of the ASCM respectively include remedy measures for prohibited, actionable, and non-actionable subsidies.

3.3.4 The impact of the ASCM on taxation

As discussed in the previous chapter, tax incentives are a popular type of subsidy, and therefore the ASCM can also apply to tax incentives once they fulfill all the criteria.

Subsidies granted in the form of tax incentives are a special category of subsidies, and therefore the ASCM has included specific rules to counteract fiscal subsidies. A distinction is made between direct and indirect taxes, especially in the category of prohibited subsidies. The ASCM allows tax adjustments by granting remissions, rebates, or exemptions for indirect taxes to avoid double taxation but not for direct taxes. Therefore, the rebate of indirect taxes on exports is not an export subsidy, whereas the rebate of direct taxes would be considered to be a prohibited subsidy.[293]

3.3.4.3 Reasons for the distinction between direct and indirect taxation in the ASCM

Taxes are normally divided into direct and indirect taxes for different reasons, most of which are still controversial.[294] Some economists hold that producers will shift the cost of indirect taxes forward to consumers as a component of the price of the goods. Such costs are added to the consumers' costs for the goods, but this forward shifting will not occur with respect to direct taxes.[295] However, other authors doubting this reasoning claim that direct taxes may also be

[293] In the illustrative list of export subsidies, provision (e) and (f) list direct tax incentives that can constitute export subsidies, and provision (g) and (h) list indirect taxes that constitute export subsidies. They are (e) the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises; (f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged; (g) the exemption or remission, in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption; (h) the exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste).

[294] A detailed historical review on distinctions between direct and indirect taxes can be seen in Charles J Bullock, 'Direct and Indirect Taxes in Economic Literature' (1898) 13 Political Science Quarterly 442-476; Alan Schenk and Oliver Oldman, *Value Added Tax-A Comparative Approach* (Cambridge Tax Law Series, Cambridge University Press 2007) 5.

[295] Anthony Barnes Atkinson, Joseph E Stiglitz and LL Lûbimov, *Lectures on Public Economics* (1980)427; Bullock, 'Direct and Indirect Taxes in Economic Literature' 463; Althunayan, *Dealing with the Fragmented International Legal Environment-WTO, International Tax and Internal Tax Regulations* 4.

shifted.[296] They consider that the distinction between direct and indirect taxes relates to "whether the person who actually pays the money over to the tax collecting authority suffers a corresponding reduction in his income. If he does, then-in the traditional language-impact and incidence are on the same person and the tax is direct; if not and the burden is shifted and the real income of someone else is affected (i.e. impact and incidence are on different people) then the tax is indirect."[297]

The theoretical justification for export rebates is found in the destination principle.[298] According to this theory, personal consumption is taxed in the country of destination, which is assumed to be the country of consumption. In other words, tax is only imposed in the country of consumption.[299] Under the destination principle, indirect taxes paid by the exporter on its purchases are refunded, i.e. exports are zero-rated.[300] As a result, exports are relieved from indirect taxes in the country of origin (exporting country) and imports are subject to indirect taxes in the country of destination (importing country). Therefore, export rebates ensure that cross-border trade is free from double taxation under the indirect tax system, which means that border tax adjustments for indirect taxes do not constitute subsidies for exports or a disadvantage to imports. This is also the reason why the ASCM admits that only the excess of the remission or exemption of indirect taxes are export subsidies.[301]

3.3.5 The application of the ASCM to tax incentives

For a tax incentive to constitute a subsidy under the ASCM, it has to fulfill all the elements of a subsidy, namely the demonstration of a financial contribution, benefits, specificity, and other existing conditions related to different categories of subsidies. To clarify the application procedure, there are three main testing steps (See Chart 1 at the beginning of Section 3.3).

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[296] For instance, Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International 2003) 54-55.
[297] Schenk and Oldman, *Value Added Tax-A Comparative Approach* 5. John Stuart Mill, *Principles of Political Economy : with Some of Their Applications to Social Philosophy* (University of Toronto Press 1965)
[298] Schön, 'World Trade Organization Law and Tax Law'.
[299] Schenk and Oldman, *Value Added Tax-A Comparative Approach* 35.
[300] K. Messere, 'International: Consumption Tax Rules' (1994) 48 Bulletin for International Fiscal Documentation 665.
[301] Footnote 1 of the ASCM states that the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed a subsidy.

The first step is to prove the existence of a financial contribution. As analyzed in the definition of subsidies, there are four forms of financial contributions. With respect to tax incentives, this financial contribution takes the form of government revenue that is otherwise due, but which is foregone or not collected. Taxes are the main source of governmental revenue, but if the government abandons the tax collecting right by means of providing tax incentives, such as tax reductions or tax exemptions, it has the same effect as providing a direct financial contribution. Therefore, the granting of tax incentives is a kind of financial contribution by governments.

After demonstrating that there is a financial contribution, the next step is to prove that tax incentives confer benefits. As discussed earlier, to determine whether a financial contribution confers a benefit, a normal method is to examine whether it places the recipient in a more advantageous position than they would have been in otherwise. Tax incentives are actually deviations from the normal tax benchmark, and therefore they enable recipients to enjoy a better-off position compared to those who do not receive the tax incentive and who have to meet the normal benchmark. Without tax incentives, the recipients would not have access to those advantages in normal market conditions. Thus, tax incentives grant benefits to recipients.

Subsequently, subsidies identified by the ASCM are specific, and therefore it is vital to show the specificity of tax incentives. The test has to be undertaken based on the category of subsidies. Prohibited subsidies are deemed specific automatically. If the tax incentive is contingent in law or in fact upon export performance or the use of domestic over imported goods, it falls within the scope of export subsidies or import-substituting subsidies. Thus, it is not necessary to prove the specificity of these tax incentives. On the contrary, for actionable subsidies, specificity is an essential element. To identify a tax incentive as an actionable subsidy, it is necessary to demonstrate that it is confined to certain enterprises or specific regions. When the tax incentive is specific, it is further required to prove that it results in adverse effects to other Members and that there is a causal link between the incentive and those adverse effects.

3.3.6 Conclusion

The ASCM can be considered to be an achievement of the previous negotiation rounds of the WTO which has promoted significant improvements with regard to international subsidy rules. The Agreement not only provides a definition of a subsidy, classification of subsidies, but it also includes remedies for subsidies and procedures for taking countermeasures. Most importantly,

subsidies in the form of tax incentives are also included in the legal framework. Therefore, it has provided a novel perspective to observe the use of fiscal subsidies and the impact on tax competition. Nevertheless, it does not mean that that WTO law can solve all the problems caused by fiscal subsidies and tax competition. In fact, there have been few cases before the WTO dispute settlement body on tax issues after the FSC cases. By addressing WTO law here, the aim is to find more juridical perspectives for a deeper understanding of the issue of subsidies in the form of tax incentives. It is also favorable to conduct a comparative research with a similar system which can be found in the European Union (EU), the EU State aid system.

3.4 Overview on the EU State aid law

Articles 107, 108, and 109 of the Treaty on the Functioning of the European Union (TFEU) are the main articles addressing State aid measures. Article 107 provides a definition of aid, which is widely used as a benchmark to identify State aids, and Article 108, Article 109 introduces procedures on State aid control, such as the interaction between the Commission, the Member States and the Council.[302] In addition, the Commission has issued a notice on the notion of State aid, as referred to in Article 107 (1) (the 2016 Notice).

This Section follows the structure outlined in Chart 2 to introduce EU State aid law and fiscal State aid.

[302] See Article 107, 108, and 109 of the TFEU.

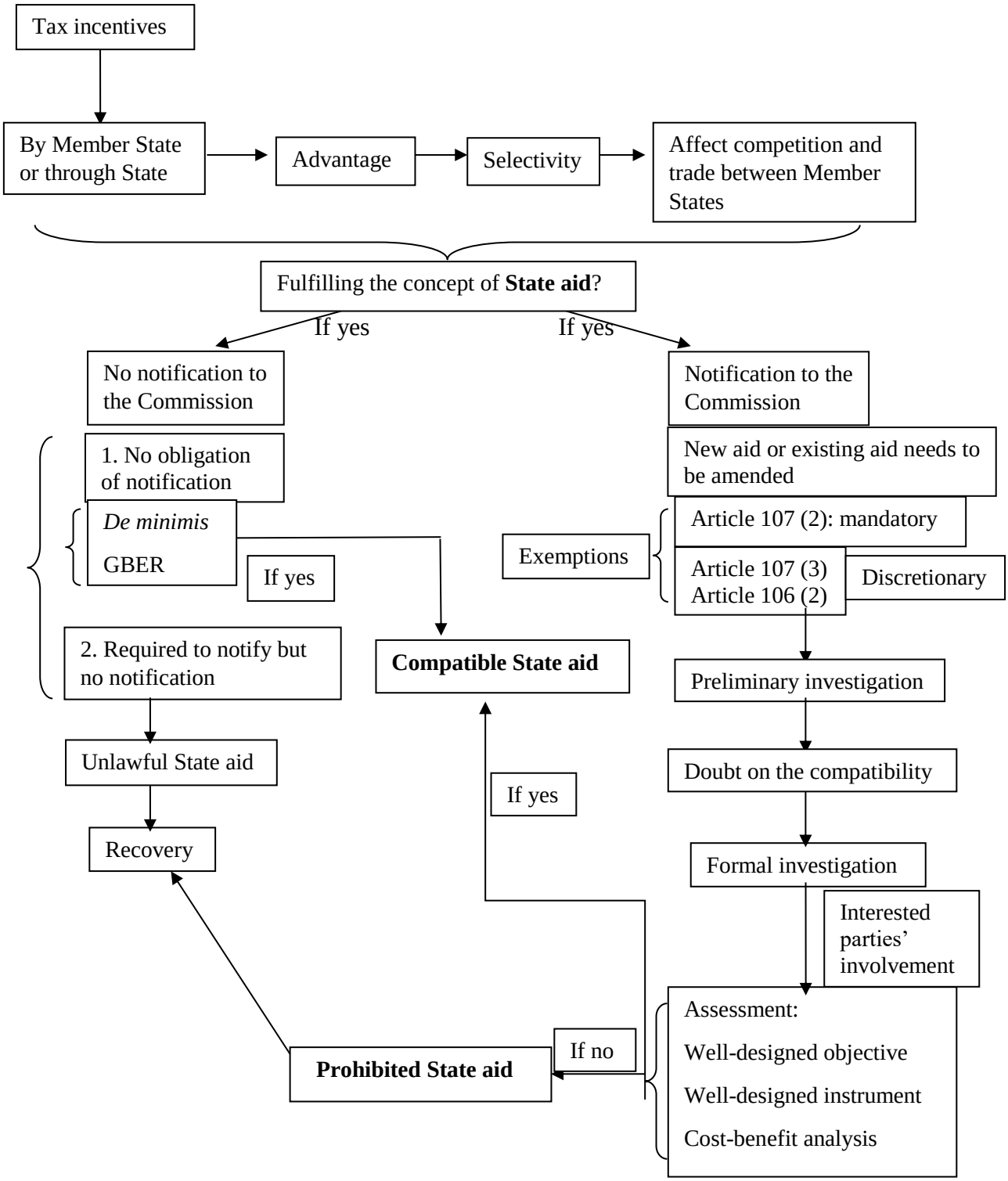
Tax incentives
By Member State or through State
Advantage
Selectivity
Affect competition and trade between Member States
Fulfilling the concept of **State aid**?
If yes
If yes
No notification to the Commission
Notification to the Commission
1. No obligation of notification
De minimis
GBER
If yes
New aid or existing aid needs to be amended
Exemptions
Article 107 (2): mandatory
Article 107 (3)
Article 106 (2)
Discretionary
2. Required to notify but no notification
Compatible State aid
Preliminary investigation
Unlawful State aid
If yes
Doubt on the compatibility
Recovery
Formal investigation
Interested parties' involvement
Assessment:
Well-designed objective
Well-designed instrument
Cost-benefit analysis
If no
Prohibited State aid

Chart 2

3.4.1 The concept of State aid

Article 107 (1) TFEU stipulates that: "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

Since State aid rules apply to aid measures 'in any form whatsoever', it applies to taxation as well.[303] As mentioned earlier, to address harmful tax competition and fiscal State aid, the Commission introduced rules on the application of State aid regulation to tax measures, which are merged in the 2016 Notion of State aid.[304] The steps to identify a fiscal State aid are identical to the steps for identifying a general State aid measure, but there are special procedures required to determine certain elements.[305]

3.4.1.1 Granted by the Member State or through State resources

The State, which grants aid, includes all public authorities such as the legislator, the judiciary, regional authorities, and public or private bodies designated by the state to grant aid.[306]

The provision of State aid through tax incentives generally would entail a loss of revenue. A loss of tax revenue is equivalent to a consumption of state resources in the form of fiscal expenditure. This rationale also applies to regional or local public bodies below the central state level.[307] Meanwhile, the fact that a tax aid scheme has a positive overall effect on national revenue is not sufficient to rule out the presence of state resources. The concept of state resources must be

[303] Article 1 (a) of Council Regulation (EU) 2015/1589 mentions: "aid shall mean any measure fulfilling all the criteria laid down in Article 107 (1) of the Treaty". See Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union [2015] OJ L248/9, see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R1589&from=EN.

[304] Section 5.4, Commission Notice on the Notion of State Aid as Referred to in Article 107 (1) TFEU [2016] OJ C262/1 (the 2016 Notice); Commission Notice on the application of the State aid rules to measures relating to direct business taxation [1998] OJ C384/3 (the 1998 Notice); Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation [2004] C (2004) 343.

[305] Ibid.

[306] See Section 3.1 imputability of the 2016 Notion of State aid; Hancher, Ottervanger and Slot, *EU State Aids* 60-61.

[307] Paragraph 48 of the 2016 Notion of State aid; Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation [2004] C (2004) 343, at para. 18.

assessed in the light of the recipient's situation, without reference to the induced effects of the measure in economic or budgetary terms.[308]

3.4.1.2 Economic advantage (any aid in any form whatsoever)

The identification of an economic advantage takes an effect-based approach.[309] According to the 2016 Notice, an advantage means any economic benefit that an undertaking[310] would not have obtained under normal market conditions, namely, in the absence of State intervention.[311] In *Italy v. Commission*,[312] the Court explained that, to assess the existence of an advantage, a comparison should be made between the financial situations of the undertaking before it received the aid and after receiving the aid to examine whether the undertaking was better off or not.[313] Thus, the form does not matter much when identifying the aid, and the focus shall be on the evaluation of the effects, i.e. the evaluation of the financial situation of the undertaking, such as whether or not the aid can improve the undertaking's financial situation or prevent a deterioration of the undertaking's financial situation.[314] The notion of an advantage is based on the analysis of the financial situation of an undertaking in its own legal and factual context with and without the aid.[315]

To determine whether a tax measure constitutes State aid, the first element is that the measure must confer on recipients an advantage, which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, including a reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or entering reserves on the balance sheet), a total or partial

[308] Ibid at para. 20.
[309] The 2016 Notice, at para. 67 and 68. The effect-based approach has been confirmed in CJEU Case C-30/59 *Steenkolenmijnen v. High Authority*: "The concept of aid is…wider than that of a subsidy because it embraces not only positive benefits, such as subsidies themselves, but also interventions…which are similar in character and have the same effect". Also in CJEU Case 173/73, *Italy v. Commission*, the Court affirmed: "Article 107 (1) does not distinguish between the measures of state intervention concerned by reference to their causes or aims but define them in relation to their effect".
[310] The entity carries out economic activities. For the notion of undertakings, see section 3.4.1.3 (1).
[311] The 2016 Notice, at para. 67; CJEU Case C-342/96 *Spain v. Commission* [1999] ECR I-2459, at para. 41.
[312] CJEU Case C-173/73, *Italy v. Commission* [1974] ECR 709.
[313] Ibid, at para. 13.
[314] The 2016 Notice, at para.68; CJEU Case C-241/94 *France v. Commission* [1996] ECR I-4551, at para. 40.
[315] The 2016 Notice, at para 68; CJEU Case C-173/73 *Italy v. Commission* [1974] ECR 709, at para. 17.

reduction in the amount of tax (such as an exemption or a tax credit), deferment, cancellation or even a special rescheduling of tax debt.[316]

3.4.1.3 Selectivity

(1) The notion of undertakings

The object of State aid shall be undertakings who engage in economic activities, regardless of their legal status and the way in which they are financed.[317] The decisive condition is that the entity carries out economic activities. The case law has consistently held that any activity consisting of offering goods and services in a market is an economic activity.[318] Thus, if these elements are satisfied, it is irrelevant that the entity is not in fact making profit or that it is not set up for an economic purpose.

(2) Selectivity criteria

Only selective measures may constitute State aid and general measures that apply to all undertakings are not State aid.[319] Tax measures, open to all economic agents operating within a Member State, are in principle general measures. If a tax measure favors certain undertakings or the production of certain goods, the measure can be regarded as selective. In the situation of determining selectivity stemming from discretionary administrative practices, to distinguish selective measures from general measures, it is necessary to determine the general benchmark as a reference first and, consequently, a comparison should be made between undertakings in the same circumstances.[320]

In order to identify selectivity, the 2016 Notice provides a three-step analysis.[321] Firstly, the reference system must be recognized. The reference system is composed of rules that generally apply to all undertakings.[322] In the case of taxes, the reference system is based on elements such as the tax base, the taxable persons, the taxable event and the tax rates. For special-purpose (stand-

[316] The 1998 Notice, at para. 9.
[317] The 2016 Notice, at para. 7.
[318] CJEU Case 118/85 *Commission v. Italy* [1987] ECR 2599, at para.7; CJEU Case C-35/96 *Commission v. Italy* [1998] ECR I-3851, at para. 36; CJEU Joined Cases C-180/98 to C-184/98 *Pavlov and Others* [2000] ECR I-6451, at para. 75.
[319] Even measures which are open to all sectors can be considered selective because *de facto* they are not open to all undertakings in the territory concerned. The 2016 Notice, at para. 117 and 118. See also CJEU Case C-143/99 *Adria Wien Pipeline GmbH* [2001] ECR I-8365, at para. 41.
[320] CJEU Case C-143/99 *Adria Wien Pipeline GmbH* [2001] ECR I-8365, at para. 41.
[321] The 2016 Notice, at para. 128.
[322] Ibid at para. 133.

alone) levies, such as levies on certain products or activities having a negative impact on the environment or health, the reference system is in principle the levy itself. However, it is on the condition that the practical effects are not selective.[323] Secondly, it must be determined whether or not the measure at issue deviates from the reference system.[324] 'Favoring' certain undertakings means that selected undertakings have more advantages than other non-favored undertakings and, as a result, the favored undertakings are better off.[325] To determine the deviation, it is inclined to adopt an effect-based approach, i.e. evaluating the effect of the measure.[326] To evaluate a "better off" position, it is necessary to view the favored undertakings compared with other undertakings that are in a similar legal and factual situation.[327] Lastly, even if there is a deviation from the reference system, one has to testify whether the measure can be justified on the basis of the nature or general scheme of the system.[328] This justification means that a measure derives from the intrinsic basic or guiding principles of the reference system or it is the result of inherent mechanisms necessary for the functioning and effectiveness of the system.[329] For instance, the basis for a possible justification could be the need to fight fraud or tax evasion, the need to take into account specific accounting requirements, administrative manageability, the principle of tax neutrality, the progressive nature of income tax and its redistributive purpose, the need to avoid double taxation, etc.[330] However, even if a derogation measure could be justified in this situation, the measure has to be proportionate to achieve the objective.[331] It is the Member State's obligation to prove how the derogation is justified by the nature and general scheme of the system.[332] Only in a few cases is this justification recognized by the court to justify tax treatment that has departed

[323] Ibid at para. 134.
[324] Ibid at para. 128.
[325] The 2016 Notice, at para. 135.
[326] CJEU Case C-487/06 *British Aggregates Association v. European Commission* [2008] ECR I-10505, at para. 85 and 89.
[327] The 2016 Notice, at para. 135.
[328] Ibid at para. 128.
[329] Ibid at para. 138; CJEU Joined Cases C-78/08 to C-80/08 *Paint Graphos and others* [2011] ECR I-7611, at para. 69.
[330] Ibid at para. 139.
[331] Ibid at para. 140.
[332] Ibid at para. 141.

from the standard system.[333] If the first two steps are fulfilled, the tax measure can be considered to be selective, but if the justification can be established, no selectivity can be recognized.

To understand the issue more clearly, it is useful to distinguish different types of selectivity.

a. Material selectivity

De jure selectivity: a tax incentive is stipulated in legislation, regulations, or any legal document and it is evident how undertakings can access the incentive.[334]

De facto selectivity: the formal criteria for the application of a tax incentive appear to be open to all undertakings and its effects favor certain undertakings in practice.[335]

In practice, it is complicated to give a definite answer as to how to determine *de facto* selectivity. According to *Italy v. Commission*, if some measures are not actually open to all economic participants, even if they do not aim at certain sectors or regions, they are still regarded as selective.[336] Therefore, the test of selectivity "is not based on the existence of concentration on certain sectors but rather on the imposition by Member States of conditions or barriers that prevent certain undertakings to benefit from the measure."[337] For instance, tax incentives that only apply to investments exceeding a certain threshold may mean that the measure is *de facto* reserved for undertakings with significant financial resources.[338]

b. Regional selectivity

If a measure does not apply to the whole territory of the country, it may be deemed to be selective for certain regions.[339] This kind of selectivity becomes complicated because of the allocation of power between the central government and intra-state authorities, i.e. autonomous regions.

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[333] Decision of 5 June 2002 on state aid granted by Italy in the form of tax exemptions and subsidies loans to public utilities with a majority public capital holding [2003] OJ L77/21, see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003D0193&from=EN.
[334] The 2016 Notice, at para. 121.
[335] Ibid.
[336] CJEU Case 173/73 [1974] ECR 709, at para. 27. See also Koen Van de Casteele and Mehdi Hocine, 'Favouring Certain Undertakings or the Production of Certain Goods: Selectivity' in Wolfgang Mederer, Nocola Pesaresi and Marc van Hoof (eds), *EU Competition Law* vol 4 (EU Competition Law Claeys & Casteels 2008) 254.
[337] Ibid 257.
[338] The 2016 Notice, at para. 122.
[339] Ibid at para. 142.

In Portugal v. Commission,[340] conflicts existed between fiscal autonomy at the sub-national level and fiscal rights at the central government level. The court held that to be considered as having the status of fiscal autonomy, a test should be carried out: does the sub-national body enjoy institutional, procedural and financial autonomy from central authorities? If all these conditions are met, the region is considered to be a fiscally autonomous region, and therefore the selective measure confined to this region does not constitute State aid.[341] The 2016 Notice has confirmed the test to identify autonomous regions.[342] Institutional autonomy means that the local authority has its own self-governing institutions that can grant incentives within its own constitutional, political and administrative status that is separate from that of the central government.[343] Procedural autonomy means a decision can be made without the central government being able to intervene directly in determining its content.[344] Financial autonomy can be established where the region is responsible for managing a budget and tax reductions.[345]

3.4.1.4 Affect competition and trade between Member States

Distortion of competition or the threat of a distortion of competition is regarded as the result of State aid. Whether it is considered that State aid is at issue is effect based. Therefore, potential distortion, which may harm competition between Member States, is prohibited by the treaty as well as actual distortion.[346] The Commission enjoys a wide discretion in determining whether there is a (potential) distortion of competition. In the case law, the Court confirmed that trade is affected if State aid measures strengthen the competitive position of the recipient compared to the other economic participants.[347]

Distortion of competition is the *prima facie* condition for a state measure to be defined as State aid. The constituent element is that the measure affects trade between Member States. An advantage granted to an undertaking, compared to other undertakings, will be assumed to distort competition and be liable to affect trade between Member States.[348]

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[340] CJEU Case C-88/03 *Portugal v. Commission* [2006] ECR I-7115.
[341] Ibid at para. 67.
[342] The 2016 Notice, at section 5.3.
[343] Ibid at para. 145.
[344] Ibid at para. 147.
[345] Ibid at para. 152.
[346] Ibid at para. 188.
[347] The 2016 Notice, at para.187.
[348] Ibid at para 190.

De minimis aid

The implementation of the 2005 State Aid Action Plan (SAAP) proposed a more refined economic approach on the evaluation of distortions. To attain the aim of less and better targeted State aid, *de minimis aid* is designed to exempt a small number of aid measures from the scope of State aid since they have little effect on competition and trade between Member States.[349] On the other hand, the Commission is more willing to focus on the most distortive and problematic public subsidies by freeing up resources previously devoted to dealing with minor cases.[350] Therefore, if measures can be defined as *de minimis* aid, they will be disregarded from being considered a measure that "affects trade between Member States", and therefore no State aid is identified in these cases.[351]

To comply with the WTO obligations and to control the risk of competition, some aid is exempted from the *de mimimis* regulation, such as export aid, sectorial aid including agriculture and fisheries sectors, transport sector. Additionally, *de minimis* aid only covers transparent aid, for which the precise amount of aid can be determined in advance, such with as loans, guarantees, risk capital, and capital injections, etc.[352]

3.4.2 Compatible State aid

Some aids are regarded as compatible with the internal market because they are in line with the objectives of the internal market despite their distortionary effect. However, compatible State aid has to satisfy strict conditions according to the TFEU and Commission regulations. The main rules

[349] The total amount of the aid granted per Member State to a single undertaking shall not exceed EUR 200,000 over any period of three fiscal years; a specific ceiling of EUR 100,000 applies to road freight transport. See Commission regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid [2013] OJ L352/1, see http://ec.europa.eu/competition/state_aid/legislation/de_minimis_regulation_en.pdf.

[350] Article 3, Commission regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid [2013] OJ L352/1, see http://ec.europa.eu/competition/state_aid/legislation/de_minimis_regulation_en.pdf.

[351] However, the 2016 Notice also confirms that the relatively small amount of aid or the small size of the undertaking which receives its does not exclude the possibility that trade between Member States might be affected. See the 2016 Notice, at para. 192; Harold Nyssens, 'De mininis' in Wolfgang Mederer, Nocola Pesaresi and Marc van Hoof (eds), *EU Competition Law*, vol 4 (EU Competition Law, Claeys & Casteels 2008) 417-423.

[352] Commission regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid [2013] OJ L352/1, Article 4.

concerning compatible State aid are stipulated in Article 106 (2), 107 (2) (3), and the General Block Exemption Regulation (GBER).

3.4.2.1 Mandatory exemptions

As established in Article 107 (2) of the TFEU, the following measures shall be deemed compatible with the internal market:

(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;
(b) aid to make good the damage caused by natural disasters or exceptional occurrences;
(c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by the division. Five years after the entry into force of the Treaty of Lisbon, the Council, acting on a proposal from the Commission, may adopt a decision repealing this point.[353]

The reason for this category of mandatory exemptions is that it is in line with the EU's objective of social protection, cohesion and solidarity among Member States. However, to be qualified as falling within one of these legal exemptions, a notification to the Commission is still necessary. After the notification, the Commission will evaluate whether or not the measures are compatible with the internal market and, once all the conditions are fulfilled, the measures will be considered to be compatible State aids.

3.4.2.2 Discretionary exemptions

(1) Article 107 (3) of the TFEU

Except for qualified State aid that shall be deemed compatible with the internal market, Article 107 (3) of the TFEU lists the other five items that may be considered to be compatible with the internal market which are at the discretion of the European Commission.

(a) Regional aid for areas where the standard of living is abnormally low or where there is serious underemployment;

[353] In practice, this article is hardly employed especially since the re-unification of Germany in 1990. The Commission also stated that it considered that there was no longer any economic justification for subsidizing these areas. See Hancher, Ottervanger and Slot, *EU State Aids* 144-145.

(b) Aid for a project of common European interest or to remedy a serious disturbance in the economy of a Member State;

(c) Sectoral aid to facilitate the development of certain economic activities and regional aid to certain economic areas;

(d) Cultural aid to promote culture and heritage conservation;

(e) Aids approved by the Council.

For all these aids, a notification to the Commission is required as well.

(2) Article 106 (2) of the TFEU

According to the Article 106 (2) of the TFEU, assistance granted to offset public service obligations may be permitted, such as transport services, health services, social housing, and assistance to elderly people.[354] In practice, the case law has set criteria for identifying the compatibility of SGEI measures and the Altmark case[355] is a landmark case for this interpretation. In this case, there was no advantage if the Member State only compensates the service provider for the costs of the service. However, the Altmark criteria must be fulfilled in order for it to be considered that State aid is not at issue.[356] Moreover, even in this situation, a notification to the Commission is also required.

(3) The Commission's assessment

Except for mandatory exemptions, the Commission enjoys more margins for appreciation to evaluate the compatibility of a State aid measure. It involves a more in-depth economic assessment of State aid. The Commission stated in the 12th report on Competition policy that it considered the following factors when reviewing proposed aid: the aid must promote or further a project that is in the Community interest as a whole; the aid must be necessary for the achievement of this result

[354] Article 106 (2) of the TFEU: "undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union".

[355] CJEU case C-280/00 *Altmark Trans* [2003] ECR I-7747.

[356] The Altmak criteria shall be fulfilled in order not to be regarded as State aid: clearly defined and entrusted public service obligations; compensation parameters established beforehand in objective and transparent manner; compensation does not exceed what is necessary to cover net costs of service and reasonable profit; and public procurement procedure or compensation based on costs of typical undertaking. Ibid, at paras. 87-95.

and the objective could not have been attained in its absence; the duration, intensity and scope of the aid must be proportional to the importance of the intended result.[357]

Following these evaluation standards, the SAAP and SAM have established a balancing test to carry out an assessment which balances between the distortion of competition created by the aid and the positive effect of the aid.[358]

The test includes the following consecutive questions:

1. Is the aid measure aimed at a well-defined objective of common interest, like an efficiency objective, an equity objective, or a transition to better functioning markets?
2. Is the aid well designed to reach the objective of common interest, i.e. does the proposed aid address the market failure or other objectives?
   Is State aid an appropriate policy instrument?
   Is there an incentive effect, i.e. does the aid change the behavior of firms?
   Is the aid measure proportional, i.e. could the same change in behavior be obtained with less aid?
3. Are the distortions to competition and the effect on trade limited, so that the overall balance is positive?
4. Is the aid transparent in this way that Member States, the Commission, economic operators, and the public have easy access to all relevant acts and information about the aid?

To make the test, the Commission adopts a more in-depth economic analysis towards an overall evaluation. However, the Commission itself should also be regulated or supervised, such as by the Court of Justice of the European Union (CJEU), to exercise its discretionary power within the scope of the Community interest.[359] Additionally, the intensity of judicial review should be limited

[357] The Twelfth Report on Competition Policy [1982], at para.160, see http://ec.europa.eu/competition/publications/annual_report/ar_1982_en.pdf.
[358] The test is adopted in the R&D&I framework and the Guidelines on Risk Capital in SMEs. See Community framework for State Aid for Research and Development and Innovation [2006] OJ C323/1; Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises [2006] OJ C194/2.
[359] As established in *Philip Morris v. Commission*, the Commission has discretion in approving State aid under Article 107 (3), the exercise of which requires that economic and social assessments must be made in the Community interest.

to verify the material accuracy of the facts and that there is no manifest error in the assessment.[360] With respect to taxation, the Commission assesses the compatibility of tax incentives in light of the general rules for compatible State aids.

3.4.2.3 The General Block Exemption Regulation (GBER)

The Commission launched the General Block Exemption Regulation (GBER) in the context of the SAAP to achieve the objective of creating a simple, user-friendly and coherent set of legislative rules. In order to simplify the assessment procedure, several categories of aid are considered compatible that do not require a notification to the Commission.

According to the GBER, block exempted aids include regional aid, small and medium-sized enterprise (SME) investment and employment aid, aid for the creation of enterprises by female entrepreneurs, aid for environmental protection, aid for consultancy in favor of SMEs and SME participation in fairs, aid in the form of risk capital, aid for research, development and innovation, training aid, and aid for disadvantaged or disabled workers.[361]

In order not to conflict with the EU's obligations in the WTO, aid to export-related activities and aid contingent upon the use of domestic over imported goods are exempted from the GBER. To fulfill the exemption conditions, some ex-ante criteria have to be met, for instance, the aid must be transparent and have an incentive effect.[362]

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[360] CJEU Case T-244/94, *Wirtschaftsvereinigung Stahl and Others v. Commission of the European Communities* [1997], at para. 3 "since the exercise of the Commission's discretion in relation to State aid involves complex economic and technical assessment, the Court's review of the legality of decisions adopted must be limited to verifying that the facts are materially accurate and that there has been no manifest error of assessment."

[361] Commission regulation (ECU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (General Block Exemption Regulation, GBER) [2014] OJ L187/1, see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0651&from=EN.

[362] Article 5 of the GBER provides examples of frequently used forms of transparent aid, such as aid comprised of grants and interest rate subsidies, loans, and fiscal measures, etc. As to the incentive effect, Article 6 of the GBER stipulates that aids granted to SMEs are deemed to have incentive effects, but, for aid granted to large enterprises, the Member State has to prove that the aid can bring positive effects, such as a material increase in the size, scope, the total amount, and the speed of completion of the project due to the aid. See Article 5 and Article 6 of the GBER.

3.4.3 Controlling procedure of State aid

In order to minimize the disadvantages of State aid and carry out the ex-ante assessment, the Commission has established specific controlling procedures in Article 108 TFEU and in procedural regulation.[363]

3.4.3.1 Controlling procedure for notified aid

Compatible State aid, such as mandatory exemptions, discretionary exemptions shall be notified to the Commission before their implementation. However, in the context of the SAM, which aims to simplify the State aid controlling procedure, no notification is required for *de minimis aid*, GBER, and individual aid awards covered by an authorized aid scheme.

For aid that must be notified, the controlling procedures are different for existing aid and new aid.[364] For existing aid, no notification is required, but the Commission shall review them continually and propose any appropriate measures to be taken in relation to the aid required by the progressive development or by the functioning of the internal market. If the recommendation with regard to the amendment is not taken by the Member State, the Commission can start an investigation into the aid immediately. For new aid, the Member State shall notify the Commission and the Commission, therefore, shall examine the aid as soon as the notification is received. During the investigation period, the Member State shall not put the measure into effect before the Commission's official decision.

When the Commission has received the notification of State aid, it shall start a preliminary investigation to examine the compatibility of the aid measure. After the examination, if the notified measure does not constitute aid or the measure is compatible with the common market, the Commission shall communicate the finding by way of decision. If the Commission finds that

[363] Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union [2015] OJ L248/9 (the Procedural Regulation).

[364] Existing aid includes aid that exists prior to the entry into force of the Treaty; aid authorized by the Commission; aid that the Commission has approved by default; aid that was held to be unlawful, but the 10-year limitation period for recovery has expired; and aid that was put into effect at a time when it did not constitute an aid and subsequently became an aid due to the evolution of the common market and has not in the meantime been altered by the Member State. New aid means all aid that is not existing aid, including alterations to existing aid. See Article 1 of the Procedural Regulation.

doubts are raised as to the compatibility of the measure, it shall initiate a formal investigation procedure.[365]

When entering the process of a formal investigation procedure, the Commission can request information from the Member State and interested parties may submit comments within one month to order to be involved in the assessment.[366] After the formal investigation, the Commission shall communicate its decisions in the Official Journal. The result of the investigation can be that the notified measure does not constitute aid, or it is compatible aid, or it may be compatible with the common market but only under certain conditions (the action may be monitored) or it constitutes State aid that shall not be implemented.

3.4.3.2 Recovery for incompatible unnotified aid

If a Member State is under an obligation to notify the Commission, but fails to do so and nevertheless implemented the aid, or has notified the aid but without the Commission's approval to put the aid into effect, the aid will be considered unlawful State aid. The Commission shall decide that the unlawful aid has to be recovered by the Member State with interest at an appropriate rate fixed by the Commission.[367]

The reason to recover aid is to ensure that the internal market remains a level playing field in all economic sectors by re-establishing the situation that existed in the market prior to the granting of the aid. Therefore, the Member State is responsible for recovering the aid from the beneficiary including interest.

In order to implement the recovery of the aid, the Commission has issued a notice to guide the recovery procedure in practice.[368] In terms of the recovering procedure, both the Commission and the Member States have an essential role in the implementation of the recovery decisions. In the recovery decision, the Commission provides a clear indication to Member States to recover a certain amount of aid from a beneficiary or a number of beneficiaries within a given period. After receiving the recovery decision from the Commission, the Member State shall determine the

[365] If, within the two months of the examination period, the Commission does not take a decision, the aid shall be deemed to be authorized by the Commission, and thus the Member State may implement the measures thereafter.
[366] Article 6 of the Procedural Regulation.
[367] Article 13 of the Procedural Regulation.
[368] Notice from the Commission towards an effective implementation of Commission decisions ordering Member States to recover unlawful and incompatible State aid [2007] OJ C272/4.

undertakings from whom the aid must be recovered and the precise amount of aid to be recovered.[369]

3.4.4 The application of the EU State aid law to tax incentives

To identify a tax incentive as a State aid, there are five testing steps (see Chart 2 at the beginning of Section 3.4).

Firstly, the tax incentive should be granted by a Member State or through state resources. The provision of State aid through tax incentives generally would entail a loss of revenue, which is equivalent to the consumption of state resources in the form of fiscal expenditure.

Secondly, there should be an economic advantage granted by the tax incentive. The advantage is effect based, so when the tax incentive grants the undertaking a better-off position compared to the non-recipients, an advantage is conferred. Tax incentives are deviations from normal benchmarks, which normally offer the recipients benefits in the form of a lower tax liability. Thus, compared with the non-recipients of the aid, a tax incentive enables the recipient to have a better-off position in the market.

Thirdly, it is necessary to demonstrate that the tax incentive is selective. Selectivity generally means that the tax incentive favors certain undertakings or certain regions. It can be *de jure* or *de facto* selective. The first step is to fix a general or normal standard, i.e. the tax benchmarks applicable to all undertakings. The next step is to examine whether there is a deviation from the general standard. The deviation is also effect based. It has to be established whether the tax incentive grants certain undertakings a better-off position when compared to other undertakings in a similar legal and factual situation. If it is considered that the tax incentive deviates from the normal benchmark, the following step is to establish whether the measure can be justified on the basis of the nature or general scheme of the system. If the justification cannot be established, the tax incentive can be recognized as selective.

Subsequently, the tax incentive must affect competition and trade between Member States. If the tax measure strengthens the competitive position of certain undertakings, it is assumed that

[369] However, Member States may always encounter difficulties in relation to recovery, but the Court takes a very strict attitude towards the inability of recovery. Only under exceptional circumstances, when it is absolutely impossible to recover the aid, is the Member State permitted to terminate the execution of the recovery. See ibid.

competition and trade are affected between the Member States by the measure. However, if the aid fulfills the conditions of *de minimis* aid, it will be exempted.

The last step is to verify the compatibility of the tax incentive. When a tax incentive satisfies all of the above elements, it is likely to constitute a State aid. However, the Member State can still find justifications allowing it to be exempted as a compatible State aid. The most frequently adopted justifications for an aid measure are discretionary exemptions and the GBER, including tax incentives for regional development, SMEs, environmental protection, research, development and innovation, etc. Once the tax incentive meets those conditions, it is considered to be compatible State aid for which it is not obliged to notify the Commission. Moreover, the Commission has discretionary power to assess the compatibility of aid according to the assessment criteria listed before.

3.4.5 Conclusion

State aid law in the EU is developing very fast, especially under the promotion of the SAM, which aims to foster growth in a strengthened, dynamic and competitive internal market. Thus, the regulation of State aid is becoming stricter but within a rational legal framework. In this context, tax incentives in the form of fiscal State aid are becoming important for the EU in the context of countering harmful tax competition and maintaining a level playing field for all the undertakings. Case law has demonstrated that State aid is adopted as a powerful instrument to deal with harmful tax competition, especially via the strict remedies. Compared with the WTO system, the EU State aid law provides another systematic model to address the adverse effects of tax incentives as subsidies.

3.5 Comparison of subsidy rules in the WTO and EU State aid law

3.5.1 Preliminary remarks

A significant function of comparative law is to provide a richer range of model solutions for a common problem existing in different legal systems or legal cultures.[370] Similarly, a comparison of subsidy rules in the WTO and EU State aid law can provide a better solution for the problems caused by subsidies.

[370] Zweigert, Kötz and Weir, *Introduction to Comparative Law* 15-16.

The basic methodology of comparative law is functional analysis.[371] To perform the functional analysis, a comparison of similarities and differences is the fundamental way of "discovering resemblances between the 'similar' or even similarities between the 'different', but more fundamentally by finding the explaining similarities between the 'different', and differences and divergences between the 'similar'".[372] Therefore, a comparison of similarities and differences in the WTO's subsidy system and the EU State aid system can be the basic methodology to carry out the comparative analysis.

Some authors have already conducted systematic comparisons of the two systems.[373] The purpose of the comparison in this section is not to compare the two systems comprehensively, but to establish a framework for a further evaluation in the following testing. Therefore, the comparison does not go into every detail, but only covers the most explicit similarities and differences.

3.5.2 Matrix of the comparison

	Subsidies in the WTO	**The EU State aid**
Object and purpose	**The WTO:** The reduction of tariff barriers and other barriers to trade and the elimination of discriminatory treatment in international trade relations; to create an open and non-discriminatory multilateral trading system; to create a level playing field for all the members to conduct trade and international business	**The EU:** Creating and safeguarding an internal market: an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the treaties
Mechanism	**the ASCM:** To regulate subsidies that distort international trade	**State aid:** To control the negative effects of State aid and to create a level playing field for Member States in the internal market
Scope	Goods in the ASCM, services in GATTS	Goods and services

[371] Ibid 34.
[372] Pierre Legrand and R. J. C. Munday, *Comparative Legal Studies Traditions and Transitions* (Cambridge University Press 2003) 240.
[373] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law*; Rubini, *The Definition of Subsidy and State Aid : WTO and EC Law in Comparative Perspective*; Luengo Hernández de Madrid, *Regulation of Subsidies and State Aids in WTO and EC law : Conflicts in International Trade Law*; Luja, *Assessment and Recovery of Tax Incentives in the EC and the WTO : A View on State Aids, Trade Subsidies and Direct Taxation*.

Definition	**I. Financial contribution made by a government or any public body** Government revenue that is otherwise due is foregone or not collected	**I. Any aid granted by a Member State or through state resources** Tax incentives: loss of revenue
	II. Confers a benefit Whether the financial contribution places the recipients in a more advantageous position than they would have been in (effect-based) A comparison must be conducted between the benefits received from the government and the benefits that would have been obtained under normal market conditions	**II. Economic advantage** Whether or not the aid can improve the undertaking's financial situation or prevent a deterioration of the undertaking's financial situation Effect-based approach to judge the existence of aid Advantage: any economic benefit which an undertaking would not have obtained under normal market conditions in the absence of state intervention
	III. Specificity **1. Subsidies limited to certain enterprises** ***De jure:*** where access to a subsidy is explicitly limited to certain enterprises by the granting authority or the legislation pursuant to which it operates ***De facto:*** use of subsidy program by a limited number of certain enterprises; predominant use by certain enterprises; the granting of disproportionately large amounts of subsidies to certain enterprises; the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy. **2. Regional subsidies** Subsidies limited to certain enterprises located within a designated geographical region within the granting authority's jurisdiction. Different tax rates of different provinces, autonomous regions are non-specific. Regional tax incentives granted by the regional government that are not available to all enterprises are specific. **3. Prohibited subsidies**	**III. Selectivity** **1. Material selectivity** ***De jure:*** State aid measures are stipulated in the legislation, which has set criteria for undertakings ***De facto:*** measures apply to all undertakings but favor certain undertakings in practice. The test for *de facto* selectivity: the imposition by Member States of conditions or barriers that prevent certain undertakings to benefit from the measure, e.g. selectivity granted by an administration's discretionary power **2. Regional selectivity** If a measure does not apply to the whole territory of a country, it may be deemed selective for certain regions. Regions that have fiscal autonomy (institutional, procedural and financial autonomy) may not constitute State aid.

	Export subsidies and import-substituting subsidies are deemed specific.	
	IV. Adverse effects **Prohibited subsidies:** Export subsidies and import-substituting subsidies are prohibited because of their adverse effects, so Members are not required to prove additionally that they cause adverse effects. **Actionable subsidies**: Injury to the domestic industry of another Member; nullification or impairment of benefits accruing directly or indirectly to other member under the GATT 1994, in particular the benefits of concession bound under Article II of the GATT 1994; serious prejudice to the interests of another member.	**IV. Affect competition and trade between Member States** The State aid strengthens the position of an undertaking as compared to other undertakings competing in intra-Community trade. *De minimis aid:* is disregarded from State aid
Exemptions	**Non-actionable subsidies** Assistance for R&D, assistance to disadvantaged regions, assistance for adapting infrastructure to new environmental requirements. This category ceased to exist at the end of 1999.	**Compatible State aid** 1. Mandatory exemptions 2. Discretionary exemptions 3. GBER: regional aid, SME aid, aid for the creation of enterprises by female entrepreneurs, environmental protection, aid for risk capital, aid for R&D&I, training aid, aid for disadvantaged workers
Ex-ante assessment	Article 25 of the ASCM: Members shall notify all specific subsidies to the ASCM Committee.	**Existing aid:** no notification is required, but the Commission shall keep constant review of the existing aid **New aid:** shall be notified to the Commission for a preliminary investigation and, if there is doubt on the compatibility, the measure will go through a formal investigation procedure. **Assessment:** is the aid aimed at a well-defined objective of common interest; is the aid well-designed to deliver the objective of common interest; is the aid appropriate; is there an incentive effect; is the aid

		proportional; are the distortions of competition and effect on trade limited, so that the overall balance is positive; is the aid transparent?
Remedies	**At the DSB level:** Members are recommended to withdraw the subsidy without delay; **At the domestic level:** the complaining members can take countermeasures towards the subsidizing members.	Unlawful State aid shall be **recovered** by the Member State **with interest**
Taxation	**For prohibited subsidies** There is a distinction between direct and indirect taxation: Rebate of indirect taxes on export is not an export subsidy, whereas the rebate of direct taxes is prohibited subsidy **Application to tax incentives** 1. Financial contribution: government revenue that is otherwise due is foregone or not collected 2. Benefit conferred: recipients enjoy a better-off position compared non-recipients under the normal tax benchmarks 3. Specificity: Export or import-substituting subsidies: tax incentives contingent upon export performance or the use of domestic over imported goods Actionable subsidies: tax incentives confined to certain enterprises or specific regions; adverse effects; causal link	**Fiscal State aid** 1. Granted by Member State or through state resources Loss of tax revenue 2. Advantage Tax incentives relieve recipients from the charges normally borne from the budgets 3. Selectivity: (1) General standard (2) Deviation from the standard (3) Justified by the nature or general scheme of the system 4. Affect competition and trade between Member States: the tax incentive strengthens the competitive position of one or more companies in the competition 5. Compatible State aid in the form of tax incentives Based on the criteria of the Commission's assessment

3.5.3 Reasons for differences

Differences of treaty provisions can be a result of the differences in the objects and purposes.[374] As mentioned earlier, the object and purpose of the WTO is the reduction of trade barriers, the elimination of discriminatory treatment in international trade relations, the creation of an open and non-discriminatory multilateral trading system, and the creation of a level playing field for all the Members to conduct trade and international business. As an essential part of WTO law, the ASCM

[374] Marco Slotboom, *Do Different Treaty Purposes Matter for Treaty Interpretation? A Comparison of WTO and EC law* (Cameron May 2006) 54-55.

is designed to regulate subsidies that distort international trade by providing a system that enables the Members to protect their domestic industries against injury caused by subsidized products.[375]

In contrast, as some authors have pointed out, the EU has a further-reaching object and purpose than the WTO.[376] The main object and purpose of the EU is to create and safeguard an internal market, an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured in accordance with the provisions of the treaties.[377] To achieve this ambitious objective, EU State aid rules, as an important part of competition policy, aim at preventing trade barriers created by aid that is incompatible with the common market.

To summarize, the WTO aims exclusively at "trade liberalization", but the EU has embarked on a process of deeper economic as well as political integration.[378] Accordingly, in the field of taxation, with respect to different levels of tax practice, the EU has a more stringent application of State aid law to taxation. Therefore, the control of subsidies in the WTO is not as strict as under EU State aid.[379] In addition, the WTO has 162 Members, many more than the number of EU Member States. It is more difficult to reach an agreement in the WTO than in the EU.[380] This is an important reason why the subsidy rules in the WTO develop slower than the EU State aid law. Moreover, the CJEU plays a fundamental role in promoting the development of State aid law. A major part of State aid law is case law, issued by the CJEU. It is considered primary law for EU

[375] Sanford E. Gaines, Birgitte Egelund Olsen and Karsten Engsig Sorensen, *Liberalising Trade in the EU and the WTO, a Legal Comparison* (Cambridge University Press 2012) 291.
[376] Federico Ortino, *Basic Legal Instruments for the Liberalisation of Trade: A Comparative Analysis of EU and WTO Law* (Hart Publishing 2004) 2; Slotboom, *Do Different Treaty Purposes Matter for Treaty Interpretation? A Comparison of WTO and EC law* 58-59; Sanford E. Gaines, Birgitte Egelund Olsen and Sorensen, *Liberalising Trade in the EU and the WTO, a Legal Comparison* 291; Ehlerman and Goyette, 'Interface between EU State Aid Control and the WTO Disciplines on Subsidies' 717; Slocock, 'EC and WTO Subsidy Control Systems : Some Reflections' 250.
[377] See Section 3.3.3 of this Chapter.
[378] Ortino, *Basic Legal Instruments for the Liberalisation of Trade: A Comparative Analysis of EU and WTO Law* 2.
[379] Luengo Hernández de Madrid, *Regulation of Subsidies and State Aids in WTO and EC law : Conflicts in International Trade Law* 482-491.
[380] The current decision making is based on the principle of consensus that if there is no objection to a decision, it will be passed. It is similar to unanimity, which requires that all parties explicitly agree to the decision. See Patrick Low, 'WTO Decision-Making for the Future' (2011) Available at SSRN: http://ssrncom/abstract=1833391 ; Jeffrey J Schott and Jayashree Watal, 'Decision Making in the WTO', *The WTO after Seattle* (The WTO after Seattle, Peterson Institute 2000) 283.

Member States. In contrast, decisions of the WTO's DSB are soft law for Members, are not directly enforceability against Members.[381]

3.6 Conclusion

This chapter introduces and analyzes the WTO's subsidy rules and EU State aid law and their application to taxation respectively. It started with an analysis of the objects and purposes of the two systems, with the purpose of looking for an external benchmark for evaluating the testing of Chinese tax incentives in the following chapters. It was revealed that the two legal regimes share the common objective of creating a level playing field for competition in the international market by regulating the abuse of governmental subsidies. It matches with the rationale analysis in the last chapter. It is the market operation, taking into account efficiency and equity considerations, that requires the two legal systems to regulate governmental intervention into the market economy. The creation of a level playing field actually implicates equity between competitors and equity for distributive purposes. Moreover, the principle of proportionality helps to further clarify fairness in the context of controlling governmental intervention legally. Thus, the intervention of governments shall be examined against the principle of proportionality as well.

This chapter also systematically analyzes the legal rules of the two systems, especially their application to tax incentives, thus formulating the testing steps for identifying a tax incentive as a subsidy in the WTO and a State aid in the EU. The two systems share common objective of regulating subsidies or State aid, but it seems that the EU State aid law develops further and faster than the WTO's subsidy rules. The chapter outlined the justifications for compatible State aid based on the efficiency and equity rationale and a strict procedure for ex-ante assessment. It also addressed concrete rules and the case law applying State aid law to taxation. Therefore, a comparative study on the issue of regulating subsidies from the two legal systems not only contributes to a deeper understanding of how to regulate subsidies legally, but it also provides a background to evaluate whether the law functions well to meet its objectives.

To conclude, the subsidy rules of the WTO are the legal standard for testing the compatibility of Chinese tax incentives, since China is a Member of the WTO. However, due to the similar objectives, the EU State aid law is a reference system for comparative testing, which presents

[381] Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law 454-455.*

differences in the testing results. The common benchmark derived from the common objects and purposes of the two systems is the criterion used to evaluate the testing results and the basis for further recommendations in following chapters. Since China has its own regulations on tax incentives in the context of domestic tax competition, the benchmark here is an external one rather than the domestic one. The next chapter introduces more information on Chinese tax incentives and the internal benchmark.

Chapter 4 The Internal Benchmark and Chinese Tax Incentives

4.1 Introduction

China is a country with a very long history. Compared to the Western world, it has its own path of development. The People's Republic of China (PRC) was established in 1949, but China's economy started to grow rapidly since 1978 when it initiated the Reform and Opening Policy. Since the Reform and Opening, China started to adopt tax incentives mainly to attract foreign direct investment (FDI). However, with the growth of China's economy, especially after China's accession to the WTO in 2001, other Members of the WTO contended that Chinese tax incentives affected international trade and requested an adjustment or termination of them.

In order to understand the relationship between Chinese tax incentives and the WTO's subsidy rules, this chapter has two parts. The first part introduces the chronological evolution of Chinese tax incentives and the background for discussing China's attitude towards tax competition. It therefore establishes an internal benchmark to evaluate China's granting of tax incentives. The second part focuses on current direct and value added tax (VAT) incentives that are specific according to the criteria of the subsidy rules in the WTO and EU State aid law. The overview of the present tax incentives prepares for the following testing and understanding of the interactions with the international benchmark. In direct tax, in 2007, China promulgated a new Enterprise Income Tax Law (EIT Law) that terminated most foreign related tax incentives and unified tax incentives in a separate chapter in the law.[382] In VAT, tax incentives are discussed in the context of transforming business tax (BT) to VAT. The research concentrates on the latest tax incentives for the testing. However, a chronological review and analysis of the background of Chinese tax incentives is necessary to understand China's rationale for granting the current tax incentives. It has to be clarified that, since the beginning of the adoption of tax incentives in China, they have been provided in the form of direct tax incentives, mainly corporate tax. Thus, the chronological review concentrates on direct tax incentives for FDI.

Before discussing Chinese tax incentives, this chapter introduces the background of China's fiscal system and tax legislation. China is a unitary country composed of 31 province-level

[382] Law of the People's Republic of China on Enterprise Income Tax, March 16, 2007, by the National People's Congress (NPC). For official English translation, see <http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471133.htm>.

jurisdictions.[383] It is fiscally centralized at the central government level, although there is a distribution of spending powers among the central and sub-national governments.[384] Legally, the central government is the sole authority to grant tax incentives. Local governments do not have the discretionary power to grant tax incentives unless it is with the central government's authorization.[385] In China, tax legislation includes national tax "laws" (fa lü)[386] enacted by the National People's Congress (NPC, the legislator),[387] "administrative regulations" (fa gui)[388] promulgated by the State Council (the government branch),[389] as well as administrative rules introduced by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT), which are ministries of the State Council.[390] The Legislation Law (LL) is the foundational statue

[383] Excluding Hong Kong, Macau and Taiwan, there are 4 centrally administered cities (Beijing, Shanghai, Tianjin, and Chongqing), 22 provinces and 5 ethnic autonomous regions (Tibet, Xinjiang, Guangxi, Ningxia and Inner Mongolia).

[384] Some authors regard China as fiscally decentralized, considering the distribution of taxing powers between central and local governments. Zhiguo Wang and Liang Ma, 'Fiscal Decentralization in China: a Literature Review' (2014) 15 Annals of Economics and Finance 751-770; Meili Niu, 'Fiscal Decentralization in China Revisited' 72 Australian Journal of Public Administration 251-263; Chunli Shen, Jing Jin and Hengfu Zou, 'Fiscal Decentralization in China: History, Impact, Challenges and Next Steps' (2012) 13-1 Annals of Economics and Finance 1-51; Wei Cui, 'Fiscal Federalism in Chinese Taxation' (2011) October World Tax Journal 455-480.

[385] Ibid.

[386] Chinese pin yin.

[387] The National People's Congress (NPC) is the supreme organ of state power in China. It is composed of NPC deputies who are elected according to law from 35 electoral units from the people's congress of provinces, autonomous regions, municipalities directly under the central government, the People's Liberation Army, the deputy election council of the Hong Kong Special Administration Region and the Taiwan compatriots' consultation election council. The NPC has the power to amend the Constitution and oversee its enforcement, to enact and amend basic laws governing criminal offences, civil affairs, state organs and other matters, to elect and appoint members to central state organs, and to determine major state issues. The NPC Standing Committee is the permanent body of the NPC. It normally meets once every two months, and is responsible to the NPC and reports to it on its work. It has legislative power, supervisory power, the power to decide upon major state issues, and the power to appoint and remove from office members of state organs. See Article 7, 8, 9 of the Legislation Law of the People's Republic of China (LL). See also the NPC's official website <http://www.npc.gov.cn/englishnpc/Organization/node_2846.htm> accessed 24 November 2015.

[388] Chinese pin yin.

[389] The State Council is China's central government, which is the executive body of the supreme organ of state power and also the supreme organ of State administration. See Article 65, 66, 67, and 68 of the LL. For the functions of the State Council, see <http://www.npc.gov.cn/englishnpc/stateStructure/2007-12/06/content_1382098.htm> accessed 24 November 2015.

[390] For more information, see Li, *Taxation in the People's Republic of China*; Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 Florida Tax Review 628, footnote 67; Wei Cui, 'What is the Law in Chinese Tax Administration?' (2011) 19 Asia Pacific Law Review 73-92.

that governs the hierarchy of the laws in China.[391] According to the LL, the Constitution has the highest legal authority in China.[392] National law has a higher legal authority than administrative regulations, local decrees and administrative or local rules; administrative regulations have higher legal authority than local decrees and administrative or local rules; [393] administrative rules and local rules have the same legal authority. [394]

It is not the aim of the research to debate on ideologies, which have already been argued from the perspectives of economics, sociology, history, etc. The use of the terms "socialism" and "capitalism" is only with the purpose of presenting the background of taxation in China.[395]

4.2 Chinese taxation from 1949 to 1978

Before introducing the historical evolution of taxation in China, it is necessary to have some knowledge about Chinese history as a background. According to the general historical division, contemporary China refers to the time after the establishment of the PRC in 1949.[396] The focus of the chapter is taxation in the PRC, especially tax incentives after the Reform and Opening in 1978, and therefore it does not describe the taxation before 1978 in detail.

Since the establishment of the PRC, China has pursued a socialist system, compared to the capitalist system in most Western countries. Before the Reform and Opening, China was isolated from the world economy, except for the contact with the former Soviet Union from 1950 to

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[391] Legislation Law of the People's Republic of China (2015 Amendment) (LL), by the NPC, 15 March 2015. See Cui, 'What is the Law in Chinese Tax Administration?' 75-77.
[392] Article 87 of the LL.
[393] Article 88 of the LL.
[394] Article 91 of the LL.
[395] According to the Merriam-Webster dictionary, socialism means "any of various economic and political theories advocating collective or governmental ownership and administration of the means of production and distribution of goods"; capitalism means "an economic system characterized by private corporate ownership of capital goods, by investments that are determined by private decision and by prices, production, and the distribution of goods that are determined mainly by competition in a free market". See Merriam-Webster online dictionary, <http://beta.merriam-webster.com> accessed 20 November 2015.
[396] Before 1949, the history of China can be divided into ancient China, imperial China, and modern China. Ancient China covers the time from 2070 BC to 221 BC before the Qin dynasty, which mainly includes Three Dynasties, Xia dynasty, Shang dynasty, and Zhou dynasty; Imperial China is from the time of Qin dynasty starting in 211 BC to the end of the Qing dynasty in 1911; Modern China refers to the establishment of the Republic of China in 1912 to the establishment of the PRC in 1949. See Ray Huang, *China, A Macro History* (M.E. Sharpe 1988); Michael Loewe and Edward L. Shaughnessy, 'The Cambridge History of Ancient China from the Origins of Civilization to 221 B.C' (1999) ;Morris Rossabi, *Blackwell History of the World : History of China* (John Wiley & Sons 2013); Xu Zhuoyun, T.D. Baker and M.S. Duke, *China: A New Cultural History* (Columbia University Press 2012).

1960.[397] Politically, China experienced political campaigns and chaos,[398] while the economic system was mainly a planned economy that the central government controlled and planned for the overall economic activities, and the means of production were publicly owned.[399]

The fiscal system at that time was a centrally controlled system, i.e. unified revenue collection and unified spending. Under the planned economy, the provincial governments collected most of the revenue from their own provinces and the central government made a spending plan for every province.[400] This kind of fiscal system was simple and efficient, but it restricted the initiatives of local governments and enterprises, as well as the development of the economy.[401] In this context, the function of taxation was very limited and simplified, since the majority of the economy was public, the mere function of taxation at that time was to levy tax from limited private businesses. During the political campaigns, the function of taxation was further diminished.[402]

After the political campaigns, China decided to concentrate on economic development and the improvement of people's living standard. In 1978, China announced the program of Four Modernizations, the modernization of industry, agriculture, defense, and science and technology.[403] In addition, China intended to introduce the market system to initiate a transition from a centrally planned economy to a market-oriented economy. To achieve this goal, the Chinese

[397] Following the international background of the Cold War, China signed a Treaty of Friendship and Assistance with the Soviet Union to receive technology transfers from the Soviet Union to stimulate the industrialization of China. The Cold War was a state of political and military tension after World War II between powers in the Western countries (led by the US and its allies) and powers in the Eastern countries (led by the former Soviet Union and its allies). See Melvyn P. Leffler and Odd Arne Westad, *The Cambridge History of the Cold War. Volume 1, Origins, 1945-1962* (Cambridge University Press 2010); Roy Bin Wong, *China Transformed : Historical Change and the Limits of European Experience* (Cornell University Press 1997) 179-190.

[398] From 1958 to 1976, China experienced the Great Leap Forward and the Great Cultural Revolution, which resulted in great chaos. See Kenneth Lieberthal, The Great Leap Forward and the Split in the Yenan Leadership, in Roderick MacFarquhar and John K. Fairbank, *The Cambridge History of China Volume 14. The People's Republic* (Cambridge University Press 1987) 291-359; Auyeung, 'Taxation Trends and Issues in the People's Republic of China: 1949 to 2006'.

[399] Joseph C. H. Chai, *China : Transition to a Market Economy* (Clarendon Press 1997) 3.

[400] Hehui Jin, Yingyi Qian and Barry R. Weingast, 'Regional Decentralization and Fiscal incentives: Federalism, Chinese style' (2005) 89 Journal of Public Economics 1719 1723.

[401] Christine Wong, 'Central-local Relations Revisited: the 1994 Tax Sharing Reform and Public Expenditure Management in China' (Central-Periphery Relations in China: Integration, Disintegration or Reshaping of an Empire?).

[402] Li, *Taxation in the People's Republic of China* 14.

[403] Ezra F. Vogel, *Deng Xiaoping and the Transformation of China* (Harvard University Press 2011) 221-226.

government introduced the Reform and Opening policy, including opening to the outside world and reforming the domestic economic system. After a long isolation from the outside world, China had been left behind compared to developed economies. Even within Asia, China could not catch up with the neighboring countries.[404] Thus, China decided to cooperate more with the international world to use the capital, skills, and technology from foreign investment, changing from an attitude of trade aversion to trade proclivity.[405]

In order to coordinate with the Reform and Opening policy, the existing tax system could not accommodate the economic changes; therefore, it was necessary to establish a new comprehensive and enforceable tax system, especially for the attraction of FDI.

4.3 Chronological review of direct tax incentives for FDI

4.3.1 1980-1991: separate tax incentives for FDI in Special Economic Zones (SEZs)

The implementation of the Open Door Policy was an initiative to introduce preferential tax regimes to China to attract FDI. At that time, China was in need of capital, technology, management skills, and access to international markets, but China did not have experience or a history of using tax incentives for FDI before.[406] Meanwhile, the neighboring Asian countries were offering various tax incentives for FDI, which put some pressure on China.[407] Therefore, the Chinese government consulted international experts on the design of tax incentives, as well as the benefits and problems that accompany them.[408] Consequently, China decided to introduce tax incentives for foreign enterprises (FEs) and foreign-invested enterprises (FIEs). On the one hand, they were aimed at realizing policy goals of economic development and competition with other

[404] The 1970s witnessed impressive economic successes of the regions of Eastern Asian, such as South Korea, Taiwan, Hong Kong, and Singapore.
[405] Chai, *China : Transition to a Market Economy* 139.
[406] Yasheng Huang, 'the Benefits of FDI in a Transitional Economy: the Case of China' in OECD, *OECD Global Forum on International Investment New Horizons for Foreign Direct Investment* (OECD Publishing 2002).
[407] From the perspective of tax competition, if China failed to build similar preferential tax regimes, China would be in a disadvantaged position compared to these regions. Ibid.
[408] Richard D. Pomp and Stanley S. Surrey, 'The Tax Structure of the People's Republic of China' (1979) 20 Virginia Journal of Intenational Law 1, cited by Halkyard Andrew and Linghui Ren, 'China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis', in Arthur J. Cockfield, *Globalization and Its Tax Discontents : Tax Policies and International Investments : Essays in Honour of Alex Easson* (University of Toronto Press 2010) 4-5; Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' 673.

Asian countries; on the other hand, they also announced to the world that China was ready to open the door by granting tax preferences.[409]

Accordingly, China established the corporate income tax for foreign and foreign invested enterprises by introducing the Income Tax Law of the People's Republic of China on Chinese-foreign Equity Joint Ventures (EJV Income Tax Law) (expired)[410] and the Income Tax Law on Foreign Enterprise in the People's Republic of China (FEIT) (expired)[411] as the initial taxation setup for foreign enterprises. These tax incentives were mainly granted to foreign enterprises established in Special Economic Zones (SEZs) in coastal areas, since the locations had a long history of contact with the outside world.[412]

In 1984, more tax incentives were granted to foreign enterprises in SEZs and 14 coastal cities[413] in the form of direct tax incentives, such as a lower tax rate for foreign enterprises, tax holidays for certain industries, tax refunds for foreign reinvestment, and a portfolio of tax incentives under the location-specific and industry-specific tax incentive regimes.[414] In addition to regional tax

[409] Zhaodong Jiang, 'China's Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts' (1997) 18 Northwestern Journal of International Law & Business 557-559.
[410] Issued by the NPC on 1 July 1979.
[411] Issued by the NPC on 13 December 1981.
[412] The SEZs include Shenzhen, Zhuhai, Shanto in Guangdong province, and Xiamen in Fujian province. The main tax incentives were reduced tax rate, tax holidays, and tax exemptions.
[413] From north to the south, they include Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai. See GuoFa [1984] No.161, Provisional Regulations for Special Economic Zones and 14 Coastal Cities on Reduction and Exemption of Enterprises Income Tax and Consolidated Industrial and Commercial Tax, by the State Council, 15 November 1984 (expired).
[414] For instance, Article 1 of the Provisional Regulations for Special Economic Zones and 14 Coastal Cities on Reduction and Exemption of Enterprises Income Tax and Consolidated Industrial and Commercial Tax by the State Council of the People's Republic of China: "a 15 percent preferential enterprise income tax shall be levied on the income derived from production, business and other sources by any joint venture, cooperative enterprises or wholly foreign-owned enterprises, for enterprises engaged in industry, communications and transport, agriculture, forestry and livestock breeding, which have a contract life of 10 years or longer, a two-year tax holiday commencing from the first profit-making year is granted followed by a 50 percent reduction from the third to the fifth year, upon application and approval by the special zone tax authorities". See by Halkyard Andrew and Linghui Ren, 'China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis', in Cockfield, *Globalization and Its Tax Discontents : Tax Policies and International Investments : Essays in Honour of Alex Easson* (2010) 6-7.

incentives, special FDI projects or activities received certain tax preferences as well, such as export-oriented and technologically-advanced projects.[415]

Since 1980, the government also adjusted the central and local tax systems to raise revenue and promote economic development. A fiscal contracting system was implemented instead of the centrally controlled system in the planned economy period.[416] Under the fiscal contracting system, the revenues were divided into central-fixed revenues, local-fixed revenues, and shared revenues. The local revenue was divided between the central and provincial governments according to predetermined sharing schemes. The idea was to apportion revenue and expenditures between the central and the local governments and to make the local governments responsible for their own profits and losses.[417] This system allowed the local governments some discretionary power to collect local revenues, but it led to a decrease of the central revenues. Once the provincial governments fulfilled their fiscal contracts, the central government could exercise little control over them.[418] Moreover, due to the complexity of the contracting methods, the fiscal gap between different regions also increased. [419]

4.3.2 1991-1993: expansion of tax incentives for FDI in the transition from the planned economy to a socialist market economy

The historical background for the tax reform was the transition to a market economy. In 1993, China officially announced its transition to a market economy.[420] It was considered as a watershed in China's economic reforms, which symbolized China's further transformation into a socialist market economy. The model of the market economy, which originated in the West and was

[415] Export-oriented enterprises were defined as "enterprises that produce goods mainly (over 70%) for export and maintain a net positive foreign exchange balance at the end of the year"; technologically-advanced enterprises were "enterprises which, with advanced technology provided by foreign investors, are able to develop new products, or upgrade existing products, and therefore earn foreign exchange through exports or import substitution". See footnote 32 and 33, cited by Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8 Florida Tax Review 675-676.
[416] Shen, Jin and Zou, 'Fiscal Decentralization in China: History, Impact, Challenges and Next Steps' 9.
[417] There were six forms of contracts: incremental contracting, basic proportional sharing, proportional sharing, and incremental sharing, remittance incremental contract, fixed remittance, fixed subsidy. See Su Ming and Zhao Quanhou, 'China's Fiscal Decentralization Reform' (The International Symposium on Fiscal Decentralization in Asia). Paper presented at the International Symposium on Fiscal Decentralization in Asia Revisited. http://www.econ.hit-u.ac.jp/~kokyo/APPPsympo04/China.pdf. 2004.
[418] Cui, 'Fiscal Federalism in Chinese Taxation' 461.
[419] Ibid.
[420] Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure, the third plenary session of the 14th central committee of the Chinese Communist Party (CCP), 14 November 1993.

adopted widely in capitalist countries, was for the first time used in a socialist country.[421] The core of the reform was to change the relationship between the government and the market by establishing a system of free and competitive enterprises so that the nature of the government-business relationship was changed into one operating at arm's length.[422] As analyzed by Wu (2003), the problem of the planned economy was that the administrative bodies allocating resources and setting tasks overlooked the importance of economic levers such as price, monetary incentives, and taxation to shape and guide the economy. The division between the economy and the society obstructed the allocation of resources, thus resulting in no competition in the market, which resulted in Chinese enterprises having difficulty to integrate into the global economy.[423] Therefore, to participate actively in the world economy, China started to transition to a market economy.

In this period, tax incentives for foreign enterprises expanded quickly with the development of the economic zones, including SEZs, coastal open cities, coastal economic zones, and inland zones.[424] In 1991, the State Council promulgated the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (FIETL) (expired), which unified the corporate income tax provisions for foreign invested enterprises and foreign enterprises.[425] In 1992, the Law of the Administration of Tax Collection[426] (revised) also became applicable to foreign enterprises.

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[421] As Deng Xiaoping, the second generation leader of China and chief architect of the Reform and Opening Policy, pointed out, socialism was not to be judged according to whether it was based on a plan or the market but on whether or not it can expand and develop the productive forces and raise people's living standard. He also explained "we should not hesitate to draw on the achievements of all cultures and to learn from other countries, including the developed capitalist countries, all advanced methods of operation and techniques of management that reflect the laws governing modern socialized production". Deng Xiaoping, *Selected Works of Deng Xiaoping*, vol III: 1982-1992 (Foreign Language Press 1994) 361-362.

[422] Yingyi Qian and Jinglian Wu, 'China's Transition to a Market Economy, How Far across the River?', in Nicholas C. Hope, Dennis Tao yang, and Mu Yangli (Eds.) 'How Far Across the River?: Chinese Policy Reform at the Millennium' (Stanford University Press 2003) 48.

[423] Ibid.

[424] Halkyard Andrew and Linghui Ren, 'China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis', in Cockfield, *Globalization and Its Tax Discontents : Tax Policies and International Investments : Essays in Honour of Alex Easson* (2010) 4-5.

[425] The nominal tax rate was 33% (30% national tax and 3% local tax), but FIEs located in SEZs and some other special areas were taxed at a reduced rate of 15%. See Article 5 and Article 7 of the FEITL.

[426] Law of the People's Republic of China Concerning the Administration of Tax Collection (expired), issued by the Standing Committee of the National People's Congress in 1992. It was amended in 1995, 2001, and 2013.

Compared to the previous stage of tax incentives, in this period, the government started to guide foreign investment on special industries, such as manufacturing, mining, communications, transportation, construction and installation etc.[427] The most common tax incentives were tax holidays, reduced enterprise income tax rates, accelerated depreciation, favorable deduction rules for certain types of expenditure, reinvestment incentives, and exemptions from withholding tax on dividends paid by FIEs to foreign investors.[428] However, the scale of regional tax incentives expanded so rapidly that the central government lost massive tax revenues. On the other hand, although the central government is the sole authority to authorize tax incentives, local governments in tax preferential regions discretionally granted tax incentives to compete for FDI, thus resulting in adverse tax competition among neighboring provinces.[429] The discretionary local tax incentives began to impair the taxing power of the central government, triggering the 1994 tax sharing reform between the central and local governments.[430]

4.3.3 1994-2007: tax incentives for FDI after the tax sharing reform and China's accession to the WTO

To transform into a socialist market economy, the tax system between the central and local government also changed. In 1994, China started the tax sharing reform, which classified taxes into central tax, local tax, and shared tax, with the purpose of strengthening the tax control of the central government.[431] Central taxes were those necessary to protect the national interest and implement macroeconomic control; local taxes were those suitable for the local administration, and shared taxes were major taxes directly linked to economic development.[432]

Following the 1994 tax sharing reform, the central government adjusted tax incentives accordingly. Local governments were warned to abolish discretionary tax incentives for FDI and

[427] Article 1 of Interim Provisions of the Ministry of Finance of the People's Republic of China Concerning Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax for the Encouragement of Foreign Investment in China's Open Coastal Economic Areas (expired), the Ministry of Finance [1988] No.91.
[428] Halkyard Andrew and Linghui Ren, 'China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis', in Cockfield, *Globalization and Its Tax Discontents : Tax Policies and International Investments : Essays in Honour of Alex Easson* (2010) 8. See also Easson, *Tax Incentives for Foreign Direct Investment* 2-4.
[429] Cui, 'Fiscal Federalism in Chinese Taxation' 461.
[430] Shen, Jin and Zou, 'Fiscal Decentralization in China: History, Impact, Challenges and Next Steps' 9.
[431] Guofa [1993] No.85, Decision Regarding the Implementation of the Tax Sharing System of Fiscal Management (the 1993 Decision), by the State Council, 15 December 1993.
[432] Ibid. For a detailed introduction to the content of the tax division, see Cui, 'Fiscal Federalism in Chinese Taxation' 468.

were forbidden to grant tax incentives by law.[433] However, the FEITL and its implementation regulations were still effective. With the growth of the economy, tax incentives expanded more deeply to inland China including the central and western China.[434]

Since the beginning of the granting of tax incentives for FDI, they concentrated in coastal areas, which have a long history of contact with the outside world.[435] However, the regional disparity between the coastal region and the interior region increased tremendously. When the coastal area enjoyed easy access to external markets and investments, the interior region lagged behind in economic growth, living standards, and infrastructure, etc.[436] Thus, it was necessary to decrease regional inequality and bolster the overall growth of the country.[437] Except for the economic reasons to reduce the increasing gap between the coastal region and the interior regions, there were also political concerns for the promotion of the interior regions. More than half of the ethnic minorities were living in the western region, and if the living standard in these areas remained lower compared to the eastern region, it would be risky for the unity of the country.[438]

In September 1999, China officially promoted the Western Development Strategy (WDS).[439] In 2000, the State Council issued a Notice on the Implementation of Several Policies of the Western Development, which explicitly pointed to grant tax incentives for the Western regions.[440] Subsequently, in 2001 and 2002, the Ministry of Finance (MoF), the State Administration of

[433] Article 3 and Article 84, Law of the People's Republic of China on the Administration of Tax Collection (LATC) (2015 Amendment), by the NPC, 24 April 2015. The Articles explicitly forbid the unauthorized tax reduction, exemption, refund, or non-collection or cessation of taxes; otherwise, the responsible governmental organs, entities or individuals shall be liable.

[434] Tax incentives expanded with the extension of the economic and technological development zones (ETDZs) to inland regions. See Zhihua Zeng, *Building Engines for Growth and Cometitiveness in China, Experience with Special Economic Zones and Industrial Clusters* (The World Bank 2010) 8-16.

[435] Hongyi Harry Lai, 'China's Western Development Program: Its Rationale, Implementation, and Prospects' (2002) 28 Modern China 445-446.

[436] Ibid.

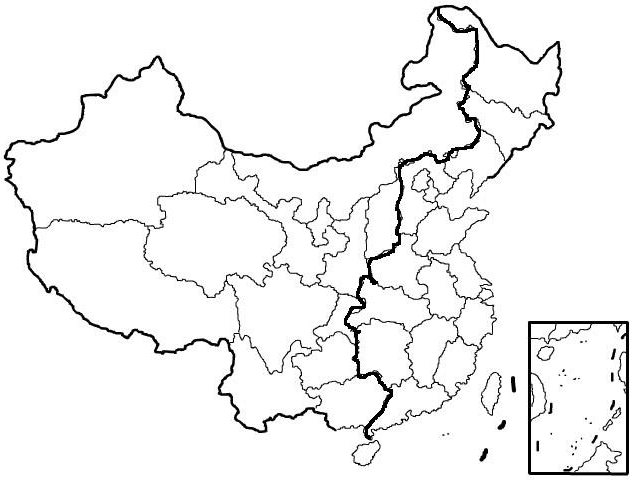
[437] Victor Shih, 'Development, the Second Time Around: The Political Logic of Developing Western China' (2004) 4 Journal of East Asian Studies 427-451.

[438] Lai, 'China's Western Development Program: Its Rationale, Implementation, and Prospects' 445-446.

[439] Western regions include Chongqing, Sichuan, Guizhou, Yunnan, Shanxi, Gansu, Ningxia, Qinghai, Xizang, Neimenggu, Guangxi, Xinjiang. Western regions are underdeveloped compared to teastern and central China. Most ethnic minorities live in these areas, which accounts for 56% of the nation's ethnic minorities. See ibid 445-446.

[440] Guofa [2000] No.33, Circular of the State Council Concerning Several Policies on Carrying out the Development of China's Vast Western Regions, by the State Council, 26 December 2000.

Taxation (SAT), and the General Administration of Customs (GAC) successively introduced detailed rules for granting tax incentives to the western region of China.[441]



On the left of the black line:

Western regions covered by the WDS

Chart 3

Nevertheless, the success of tax incentives for FDI encountered challenges when China joined the WTO in 2001. After the accession to the WTO, China was required to adjust its tax incentives in order to realize its promises of accession and fulfill its obligation as a Member, i.e. to open its domestic market fully from the inbound perspective and toremove trade barriers including subsidies for enterprises from the outbound perspective.[442] Thus, the export- and import-orientated tax incentives for foreign enterprises and the preferential tax treatment for FDI became the focus of the debate. After the accession to the WTO, China had a five-year transitional period from 2001 to 2006 to change the debated tax incentives. It indeed lowered rates for tariffs, eliminated certain trade barriers, but substantial tax incentives for foreign enterprises still existed.[443]

[441] The major tax incentives are reduced tax rates and tax exemptions. See Caishui [2001] No.202, Notice on Tax Incentives Issues Related to the Western Development, by the MoF, the SAT, and the General Administration of Customs, 30 December 2001 (expired); Caishui [2002] No.47, Notice on the Implementation of the Relevant Taxation Policies for the Western Development, by the SAT, 5 October 2002 (expired).

[442] The Protocol of China's Accession to the WTO. See https://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm#chn.

[443] This period was regarded as "the fall" of Chinese tax incentives for FDI by some scholars. See Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' 677-678; Chen, *China's Integration with the Global Economy, WTO Accession, Foreign Direct Investment and International Trade* 29.

4.3.4 2007-2013: tax incentives after the New Enterprise Income Tax Law (EIT Law)

After the five-year transitional period in the WTO, it was time for China to fulfill its obligations to rearrange the tax law system comprehensively. Meanwhile, the Chinese government considered that the time was ripe to implement the reform, considering the outcomes of the efforts of the previous decades in relation to economic development. As some authors pointed out, the government was confident that even without those preferential tax incentives, China's special advantages established attractive factors for FDI, such as a stable investment environment, a large and fast-growing domestic market, low labor costs, abundant and well-educated human resources, good infrastructure, rich natural resources, strong economic growth trends, etc.[444]

At the same time, China promulgated the new Enterprise Income Tax Law (EIT Law) in 2007.[445] The new EIT Law terminated the situation that foreign and foreign-invested enterprises enjoyed more preferential tax incentives than domestic Chinese enterprises.[446] After this new law, official tax incentives were no longer granted only to foreign enterprises, as any enterprise satisfying certain conditions was eligible for the tax incentives stipulated in the EIT law. It not only unified the FEITL and the Interim EIT Regulations, but it also introduced new concepts and provisions. It had realized "four unifications": unification of the income tax law applicable to both domestic and foreign-funded enterprises, unification of the tax rates, unification and standardization of the deductions in computing taxable income, and unification of tax incentives.[447]

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[444] Chunlai Chen, 'The development of China's FDI laws and policies after WTO accession' (2009) Rising China: Global Challenges and Opportunities 93-94; Jinyan Li, 'Fundamental Enterprise Income Tax Reform in China: Motivations and Majore Changes' (2007) December Bulletin for International Taxation 522. According to the 2005 Foreign Direct Investment Confidence Index (A.T. Kearney 2005), China was ranked as the most attractive FDI location in the world, and it maintained this position until 2007. The 2005 Foreign Direct Investment Confidence Index, A.T. Kearney Global Business Policy Council, 2005, cited by Chen, 'The development of China's FDI laws and policies after WTO accession' 93-94.

[445] Law of the People's Republic of China on Enterprise Income Tax, by the NPC, 16 March 2007. For official English translation, see http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471133.htm.

[446] The Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises and its implementation rules were repealed by the new EIT law.

[447] In order to ease the fear of foreign investors who previously enjoyed preferential tax treatment, the new law allowed existing FEs and FIEs to continue to enjoy the tax preferences until 2013 or until the specified period was over. See Article 57 of the EIT Law.

4.3.5 Conclusion

The changes in the tax incentives for FDI for the past decades are a demonstration of the tremendous development of China's economy and society. Tax incentives for FDI have undergone a process of "rise and fall".[448] Initially, tax incentives were introduced to SEZs as a trial to draw FDI; when tax incentives displayed effects for FDI and economic growth, the government adopted the incentives as a tool to guide the direction of investment, such as exportation, and expanded the scope of the incentives. Therefore, before 2007, the time can be considered as "the rise" of tax incentives for FDI. The evolution of tax incentives in this period presented some specific characteristics. First, most tax incentives were in the form of direct incentives such as lower tax rates, tax exemptions or reductions, tax holidays, and so on, which seemed efficient to attract FDI, but they also caused problems of revenue loss and intensified local tax competition. Additionally, tax incentives were concentrated in specific regions for export-oriented enterprises. Furthermore, there was no order or unified code of tax incentives for FDI.

However, many factors called for the reform of these incentives, the most significant of which were China's strengthening economic power and the WTO requirements. When China decided to join the WTO, it was prepared to open its domestic market to engage in international competition, but preferential tax treatment for FDI not only harmed the competition on its domestic market, but it also affected outbound competition with other countries. Thus, after the five-year transitional period permitted by the WTO, in 2007, it was time to unify differential tax treatment for foreign and domestic enterprises and to terminate most foreign related and regional tax incentives. Consequently, the EIT Law announced "the fall" of Chinese tax incentives.

4.4 Internal benchmark: a level playing field for competition in China

4.4.1 The background of the socialist market economy

To understand the concept of the socialist market economy, the premise is to comprehend the socialist system of China. According to the Constitutional Law, China is a socialist state under the people's democratic dictatorship led by the working class and based on the alliance of workers and peasants. The socialist system is the basic system of China.[449] The basis of the socialist economic system of China is socialist public ownership of the means of production, namely, ownership by

[448] Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' 669-712.
[449] Article 1, Constitution of the People's Republic of China (2004 Amendment).

the whole people and collective ownership by the working people. The Constitution also confirms that the state-owned economy is the leading force in the national economy, and therefore the state ensures the consolidation and growth of the state-owned economy. However, considering the economic situation of China, the Constitution allows diverse forms of ownership to coexist.[450] Therefore, it has provided the legal basis for the existence of private ownership and mixed ownership, which are the main elements of a market economy.

The original objective of introducing the market economy system into China was to promote economic growth, thereby changing from a centrally planned economy with major public ownership to private ownership. China mainly adopted Karl Marx's theory of historical materialism, i.e. the relationship between the productive forces and the productive relations, to justify the transition to the market economy.[451] Based on this theory, a market economy is just a form of productive relations that reflects and matches the development of the productive forces in capitalist countries, but it does not solely belong to capitalism. The same form of productive relations can exist in different social systems once it fits with the level of the productive forces there. In China's situation, once the market economy matches the level of productive forces in China, not only can it survive there, but it can also contribute to the development of the productive forces as a form of productive relations.[452] Therefore, once the market was established in China, the major rules of market operation also apply.

China's transition to a market economy was a "gradualist" approach.[453] China takes a step-by-step approach by adopting some market-oriented reforms while maintaining much of the socialist

[450] Article 6, Constitution of the People's Republic of China (2004 Amendment): "in the primary stage of socialism, the State upholds the basic economic system in which the public ownership is dominant and diverse forms of ownership develop side by side and keeps to the distribution system in which distribution according to work is dominant and diverse modes of distribution coexist".

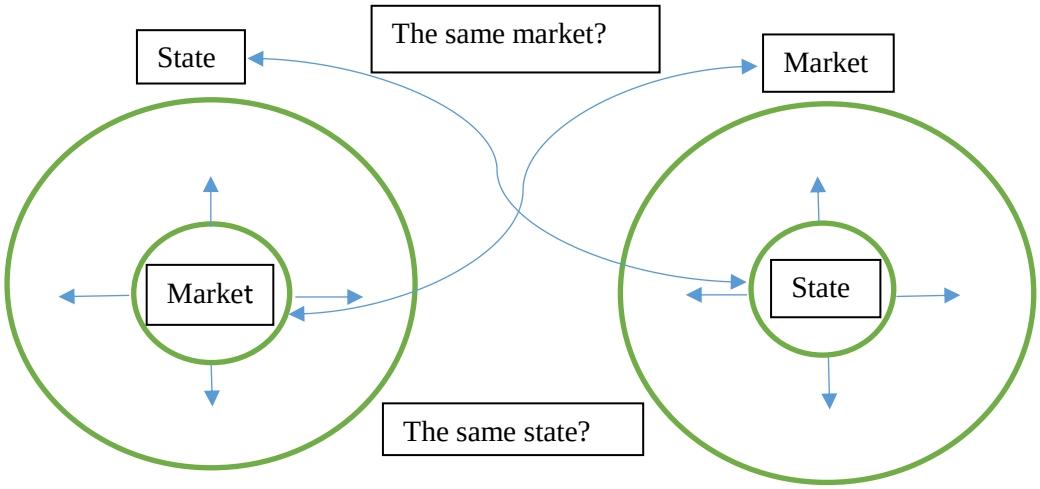
[451] Based on this theory, productive forces are facilities for creating or making usable material goods, facilities that are necessary to meet the physical demands of the production process. Productive relations are "relations of effective power over persons and productive forces, which govern processes of production". The level of development of the productive forces is the determining factor for the development of society. The relationship between productive forces and productive relations is mutually active. Productive forces determine the level of productive relations, while productive relations react to productive forces. Karl Marx, Friedrich Engels and C. J. Arthur, *The German ideology. Part one* (Electric Book Co. 2001) 32, 56, and 63.

[452] Mingxing Cao, *Differentiation of the Generation on the Modern Tax Law, Pole Analysis and Case Commentaries of the Background Elements for China and the United States* (China Taxation Press 2009) (in Chinese) 48-51.

[453] The "gradualist" approach means a step-by-step transition compared to the "big bang" approach adopted by the former Soviet Union and Eastern European countries. It entails changing all elements of the centrally-

planned economy systems for the transitional period. During this process, China initiated reforms targeting at the core problem of the relationship between the government and the market. The major actions were reforming the existing state-owned enterprises (SOEs), promoting new private enterprises (mainly small and medium enterprises), and establishing the rule of law.[454] This reform process was accompanied by a flourishing FDI as well. In order to open the economy to the world and to attract FDI, China had to integrate into the world economy and to accept the Western market economy model and its common rules. It requires a transformation of the government's role from ordering and planning to macro-control in general.[455] Moreover, the accession to the WTO accelerated the progress of China's integration into the world.

4.4.2 The socialist market economy and the Western market economy



Market economy in China **Market economy in the West**

Chart 4

planned economy as quickly as possible into a capitalist economy by the privatization of property and enterprises, freeing prices by market forces, eliminating monopolies, fostering market competition, and opening the market to the outside world, etc. For the distinction between the "big bang" approach and the "gradualist' approach, see Martin King Whyte, 'Paradoxes of China's economic boom' (2009) 35 Annual Review of Sociology 371.

[454] Yingyi Qian and Jinglian Wu, 'China's Transition to A Market Economy', *How Far Across the River? Chinese Policy Reform at the Millennium* (How Far Across the River? Chinese Policy Reform at the Millennium, Standford University Press 2003) 48-61.

[455] Michael W. Bell, Hoe Ee Khor and Kalpana Kochhar, *China at the Threshold of A Market Economy* (International Monetary Fund 1993) 73-74.

4.4.2.1 Differences: the market operates under the state's macro control (SOEs)

Although China officially announced that it introduced a market economy since 1993, the question is whether or not this market economy is identical to the Western idea of a market economy. In the Western model of a market economy, despite the fact that relationship between the market and the government is consistently in a dynamic process, the market always plays an essential role in resource allocation, and the government plays a subsidiary role to the market. [456] Nevertheless, the degree of government intervention is growing due to market failures.[457] As illustrated in Chart 4, the state plays an increasing role to achieve efficiency and equity in the market, but it still functions under the framework of the market.

In contrast, China uses the concept of a socialist market economy to distinguish from the common one. Under the socialist system, the market operates under the framework of the state, which is within the control of the state's governance. In the period of the centrally planned economy, the state had absolute control over all business activities. Even after the introduction of the market economy in China, the market still operates under a framework in which that state-owned enterprises (SOEs, public ownerships) and collective ownerships are the main forces. However, the scope of the market and the freedom of the market participants are expanding with less and less government intervention. As announced by the government, the trend is to let the market play a more and more decisive role in the allocation of resources with macro-regulation by the state.[458]

Compared to the market economy system in the West, the market in China is not fully a free market, since there is limited market access for private and foreign enterprises in certain areas that are only open to SOEs, such as electricity, coal, civil aviation, petroleum and petrochemical,

[456] See the efficiency requirement in the market in Section 2.2.1 in Chapter 2.

[457] John Maynard Keynes was a pioneer who was critical about the free market economy and advocated governmental regulation of the market during the time of the Great Depression in the 1930s. Chapter 6 goes into a further analysis of this issue. See John Maynard Keynes, *The End of Laissez-faire* (Leonard & Virginia Woolf at the Hogarth Press 1926).

[458] At the Third Plenary Session of the 18th Central Committee of the Chinese Communist Party (CCP) on 12 November 2013, the Committee approved the Decision of the Central Committee of the CCP on Some Major Issues Concerning Comprehensively Deepening the Reform (the 2013 Decision). The 2013 Decision announced, "let the market decide the allocation of resources, the primary task is to build an open and unified market with orderly competition". For a non-official English version of the 2013 Decision, see the English version of the 2013 Decision, *China Daily* (18 November 2013) <http://language.chinadaily.com.cn/news/2013-11/18/content_17112855.htm> accessed 10 March 2016.

telecommunications, and the like.[459] Under the current framework of a socialist market economy, the state maintains sole ownership or absolute control over the strategic industries and a strong control position with regard to the pillar industries.[460] In 2006, the state-owned Assets Supervision and Administration Commission (SASAC), the institution authorized by the state Council to administer and supervise state-owned assets, identified seven "strategic industries" and five "pillar industries". Strategic industries include defense, electricity generation and distribution, petroleum and petrochemical, telecommunications, coal, civil aviation, and waterway transport, while pillar industries include machinery, automobiles, information technology, construction, steel, base metals and chemicals.[461] Due to the significance of these industries, the central government has strong control over the market access to them.[462] Thus, the major enterprises in these industries are SOEs. In summary, the market still operates under the state's macro control.

4.4.2.2 Similarities: basic function of the market is the same

The two systems share similarities. Although the market operates under the state's macro framework in China, it is still a market in which the basic rules of the market are also applicable. As analyzed in Chapter 2, the key feature of a market economy is the private ownership, i.e. resources are owned by private individuals, which make both trading parties better off.[463] In order to protect individuals' private ownership, to increase efficiency and equity in the market, it is necessary to introduce the rule of law to guarantee fair competition in the market.

With further integration into the world economy, the market economy system is also becoming mature and complete in China. Comparing the basic elements of China's market economy with the Western market economy, it is obvious that they are the same. The protection of private ownership and the respect for the individual's choice are fundamental issues for the market's operation. Therefore, despite the fact that the function of the state differs in degree and scope,

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[459] Andrew Szamosszegi and others, 'An Analysis of State-owned Enterprises and State Capitalism in China' (2011) 33-34.

[460] Absolute control normally means the majority of ownership, but strong control means 30 to 50 percent shares of ownership. Andrew Szamosszegi and others, *An Analysis of State-owned Enterprises and State Capitalism in China* (Capital Trade, Incorporated for US-China Economic and Security Review Commission 2011) 33.

[461] Ibid 33-34.

[462] For foreign investment, a list of market access to different industries can be found in the Catalogue for the Guidance of Foreign Invested Enterprises (amended in 2015). There are three categories of foreign investment: encouraged, restricted, and forbidden. See Section 4.6.2.2 in Chapter 4.

[463] Sobel, 'Welfare Economics and Public Finance' 21-22.

within the framework of the market economy, the basic function of the market is the same for both systems.

4.4.3 Internal benchmark: a level playing field in China

4.4.3.1 A level playing field for tax competition

Under the socialist market economy in China, in order to keep the economic growth and to further integrate into the world economy, it is necessary to protect the market efficiency. Therefore, there should also be a level playing field for competition in the market. Accordingly, it is necessary to regulate the granting of tax incentives that distort the establishment of such a level playing field in domestic China. Legal regulation, i.e. the rule of law, is a strong guarantee to maintain such fair competition. It further involves a systematic internal legal control of tax incentives in China.

There is not yet a unified legal regulation of the granting of tax incentives in China. The current laws that can be applied to regulate the *de facto* tax competition in China are the Law of the People's Republic of China Concerning the Tax Administration and Tax Collection (LATC)[464] and Anti-unfair Competition Law of the People's Republic of China (AUCL).[465] The AUCL aims at safeguarding the development of a socialist market economy, thus encouraging and protecting fair competition.[466] The objective of the LATC is to regulate tax collection and to forbid the discretionary granting of tax incentives.[467] Nevertheless, neither law has detailed rules for the systematic regulation of tax incentives.

After the implementation of the EIT Law, China realized the importance of creating a level playing field in the domestic market by further regulating the use of tax incentives. In 2013, China officially promoted the reform of the taxation systems in order to optimize resource allocation,

[464] Law of the People's Republic of China on the Administration of Tax Collection (2015 Amendment) (LATC), by the NPC, 24 April 2015.
[465] Anti-Unfair Competition Law of the People's Republic of China (AUCL), by the NPC, 2 September 1993.
[466] Article 1 of AUCL: this law is drawn up in order to safeguard the healthy development of the socialist market economy, encourage and protect fair market competition, prohibit unfair competition, safeguard the legal rights and interests of managers.
[467] Article 1 of LATC: this law has been formulated with a view to strengthening the administration of tax collection, regulating tax collection and payment, guaranteeing the tax revenue of the State, protecting the legitimate rights and interests of taxpayers and promoting economic and social development. Article 3 of LATC: no governmental organs, entities or individuals may be permitted without authorization, by violating laws or administrative regulations, to make decisions regarding the collection of tax or the cessation thereof, the reduction, exemption or refund of tax, the payment of tax dodged or overdue or decisions in conflict with other tax laws or administrative regulations.

maintain market unity, and promote social equity, etc.[468] Most importantly, it was pointed out that to promote equality in relation to tax burdens and fair competition, the central government would have to strengthen governance in relation to tax incentives, especially regional tax incentives. All tax incentives would be made clear in tax laws and regulations. In addition, it would clean up the existing forbidden tax incentives and improve the collection and management system of central and local taxes.[469]

In 2014, the Chinese State Council issued a Notice on the Clearance of Tax and Other Incentives.[470] It was the first time that an official document pointed out the adverse effects of tax incentives to the international trade. "Some tax incentives have disturbed the order of the market, affected the effect of national macro-economic control, and are likely to breach China's promises to foreign countries thereby triggering international trade disputes".[471] In 2015, the SAT issued a directory synthesizing all the official tax incentives that are effective until September 2015.[472] It greatly strengthened the transparency of the current tax incentives and made them more convenient for taxpayers to enjoy.

[468] The 2013 Decision confirmed that it was necessary to improve legislation, clarify powers and responsibilities, reform the taxation system, stabilize tax burdens, have transparent budgets, increase efficiency, and establish a modern fiscal system to stimulate the initiative of both the central and local governments. See V of the 2013 Decision. The fiscal reform is accompanied by a balance between the role of the government and that of the market. It is important to let the market play a decisive role in allocating resources. See I (3) of the 2013 Decision.

[469] V (18) of the 2013 Decision. As explained by the Minister of Finance, the current tax incentives, especially regional tax incentives were excessive. Some local governments discretionally render tax relieves through disguised methods, which has seriously affected the State's tax regulation and fair competition in the market. They must be cleaned up and consolidated. No new regional tax incentives would be approved in principle because they will be regulated uniformly by tax laws and regulations. Discretionary tax incentives were strictly forbidden. See Lou Jiwei, Eliminate the Drawbacks of the Fiscal System, Establish a Modern Fiscal System, *Xinhua News* (21 November 2013) <http://www.MoF.gov.cn/zhengwuxinxi/caizhengxinwen/201311/t20131121_1014330.html> accessed 21 August 2014.

[470] Guofa [2014] No.62, Notice on the Clearance of Tax and Other Incentives, by the State Council, 27 November 2014.

[471] Ibid.

[472] The SAT notice [2015] No.73, Notice on the Issuing of the Code Directory of Tax Incentives, by the SAT, 29 October 2015; the SAT notice [2015] No.76, Notice on the Issuing of Administrative Regulation of Corporate Tax Incentives, by the SAT, 12 November 2015.

In summary, under the socialist market economy, fair competition in the market should be respected in China, and therefore the creation of a level playing field for competition in the market should also be the internal benchmark for regulating Chinese tax incentives.

4.4.3.2 The content of a level playing field

The creation of fair competition should be the benchmark for evaluating China's granting of tax incentives. However, considering China's economic and social background, the concept of a level playing field needs further clarification.

In China's circumstances, to understand the meaning of a level playing field, one should refer to the principle of equality, i.e. treating equals equally and unequals unequally, which was already introduced in the external benchmark in Chapter 3.[473] Considering the imbalanced development of different regions and industries in China, there should be different treatment with respect to tax incentives as well.[474] This rational is similar to compatible State aid in the EU. In order to safeguard a common market and fair competition, the concept of the level playing field in the State aid regime takes into account the situation of disadvantaged regions and activities or enterprises that require more governmental support due to the market's inefficient functioning. It treats the same situations identically but different situations differently. When defining the concept of a level playing field as the internal benchmark in China, this rationale is the same. For instance, with respect to regional disparities in China, the level playing field shall grant certain exemptions or possibilities of compatibility to some areas with certain conditions.[475] To control the scope of exemptions, the principle of proportionality is also applicable.

4.4.3.3 The internal benchmark shares the same essence with the external benchmark

Comparing the internal benchmark with the external benchmark, it is obvious that the two benchmarks share the same essence. The external benchmark derives from the economic rationale of regulating tax incentives, which is also the common object and purpose of the two legal systems, the WTO's subsidy rules and the EU State aid law. It reflects the relationship between the government and the market under most Western countries' market economy systems.

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[473] See Section 3.2.4.2 of Chapter 3.

[474] Joseph M. Dodge, 'Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles' (2004-2005) 58 Tax Law Review 399-461.

[475] Frans Vanistendael, 'Fiscal Federalism, Are There Lessons to be Learnt for China?' (2011) 17 Asia-Pacific Tax Bulletin 419, 426.

The concept of a level playing field actually represents what should be China's position towards tax incentives in the context of the international trade and competition. Despite the differences on the function of the state and the market, the operation of the market requires basic common rules, i.e. fair competition in the market that is guaranteed by the law. During China's reform and opening process, the basic framework of the market economy has been established across the entire country.[476] A market economy requires a fair competition environment and mechanisms that balance competing interests and, thus, a mature and well-functioning legal system is necessary to guarantee the operation of the market economy. Although the social and political background in China is different from many Western countries, the creation of a level playing field is essential for economic growth and the well-being of the people.

Therefore, the concept of a level playing field in both the external and the internal benchmarks should be interpreted via the same fundamental principles, the principle of equality and the principle of proportionality. The specific content of the level playing field in each benchmark may vary due to the concrete circumstances, such as the different situations between the international standard and China's particular economic background. Nevertheless, the pursuit and maintenance of fair competition in both the international and China's domestic market should be the common benchmark to evaluate the function and position of Chinese tax incentives in the context of international trade and competition.

4.4.3.4 Conclusion

The context of establishing an internal benchmark for the evaluation of tax incentives in China is to understand the socialist market economy. The relationship between the state and the market under such a system is different from its counterpart in a Western market economy system. In China, the market operates under the framework of the state, and the state has greater intervention into the market. State ownership is still the leading force of the economy, so there is limited market access for private ownership in certain areas. However, the basic market rules still should be applicable in the market in China, especially with the growth of the market system. The efficiency and equity considerations in the market require China to create a level playing field for competition. The concept of this level playing field shares the same essence with the external benchmark

[476] Athar Hussain and Juzhong Zhuang, Enterprise Taxation and Transition to a Market Economy, in Donald J.S. Brean, *Taxation in Modern China* (Routledge 2013) 43-68.

meaning that, when interpreting fair competition, the principle of equality and the principle of proportionality should be taken into account. In China's circumstances, the level playing field should cover regional disparities and the imbalanced development of various industries.

4.5 Matrix of tax incentives in China from 1949 to 2015

Time	Background of the time	Tax measures
1949-1978	Establishment of the PRC Socialist system Planned economy Political campaigns Isolated from the world economy	Fiscal system: a central controlled system Unified revenue collection and unified spending Diminished role of taxation
1978	Reform and Opening Reform domestic economy and open to the outside world Start to introduce market economy and to attract FDI	Necessary to introduce a new and comprehensive tax system to the economic changes
1980-1991	Attraction for FDI	Beginning of tax incentives in China 1980: Income tax law of the PRC on Chinese foreign equity joint ventures (EJV income tax law) 1981: Income tax law on foreign enterprises in the PRC (FEIT) Tax incentives for FDI in SEZs (trial to open the door) 1984: more tax incentives for FDI in SEZs and 14 coastal cities 1991: Income tax law of the PRC for enterprises with foreign investment and foreign enterprises (FIETL): unification of CIT for foreign invested enterprises and foreign enterprises
1993	Official announcement of the transition from a centrally planned economy to a socialist market economy	1980-1993: fiscal contracting system The revenues were divided as central-fixed revenues, local-fixed revenues, and shared revenues The local revenue was divided between the central and provincial governments according to pre-determined sharing schemes.
1994	To establish a system of free and competitive enterprises wherein the nature of the government-business relationship is changed into an arm's length relationship	Tax sharing reform: Central tax, local tax, and shared tax

1999	Western Development Strategy	Tax incentives for Western regions
2001-2006	Accession to the WTO Five-year transitional period	Fulfillment of the obligation as a WTO Member Changes of tax incentives
2007-2013	To further fulfill the obligations in the WTO China's increasing confidence on attracting FDI without differential tax incentives	2008: the new Enterprise Income Tax Law Five-year transitional period for the former foreign-favored tax incentives
2013-2014	The 18th Central Committee of the Chinese Communist Party (CCP)	Further reforms of tax incentives To create fair competition in the market
2014	The Fourth Plenary Session of the Eighteenth Central Committee of the CCP The establishment of the socialist rule of law with Chinese characteristics	Notice on the Clearance of Tax and Other Incentives To establish and maintain an open and competitive market system
2015	Further cleaning of tax incentives	The SAT issued a directory synthesizing all the official tax incentives

4.6 The present direct tax incentives

This section introduces the present direct tax incentives after the promulgation of the EIT Law. The main sources of the tax incentives are laws, regulations, or circulars issued by the SAT or the MoF. Discretionary tax incentives granted by local governments are not in the discussion due to the limited availability of data. In 2015, the SAT compiled all the official tax incentives that were effective until 2015.[477] It provides a relatively comprehensive and authoritative source of tax incentives for further testing. The present tax incentives introduced in this section are mainly from the SAT's inventory.

In order to conduct the testing of Chinese tax incentives with the subsidy rules of the WTO and EU State aid law, the tax incentives are classified according to their specificity, the essential criteria to determine whether they are subsidies or State aid. Both of the WTO and EU State aid

[477] The SAT notice [2015] No.73, Notice on the Issuing of the Code Directory of Tax Incentives, by the SAT, 29 October 2015; the SAT notice [2015] No.76, Notice on the Issuing of Administrative Regulation of Corporate Tax Incentives, by the SAT, 12 November 2015.

systems classify specificity as either industrial or enterprise specificity and regional specificity. Hence, it is important to categorize Chinese tax incentives based on these criteria.

4.6.1 Introduction of the EIT law regime

Before discussing specific direct tax incentives, this section introduces the general direct tax incentives under the EIT law regime. It serves as a background to understand the extent of the tax incentives in China.

4.6.1.1 Residence

Enterprises are subject to enterprise income tax under the EIT Law and residence is the factor to determine the status of the enterprise for taxation. Resident enterprises are subject to tax on their income from inside and outside China; non-resident enterprises are subject to tax only on their income sourced in China. According to Article 2 of the EIT Law, a resident enterprise is an enterprise established in China or an enterprise that is created under a foreign law but has a place of effective management in China.[478] FIEs registered in China are tax resident enterprises. FEs with the place of effective management in China are also classified as tax resident enterprises. An FE without its effective management based in China is taxed according to whether it has a permanent establishment in China or not.[479]

4.6.1.2 Taxable income

The sources of taxable income include the sale of goods, the provision of services and transfers of property, dividends, interest, rents and royalties, and donations and other types of income.[480] Non-taxable income includes funds received from government finance departments and fees collected for services provided by government agencies, non-profit enterprises or social organizations in accordance with the relevant laws and regulations. Excluded income also includes

[478] Enterprise established in China means an enterprise, non-profit entity, social organization or other type of entity that derives income and is created in accordance with Chinese laws or administrative regulations. See Article 3 of the EIT Law. Place of effective management refers to the place where the substantial and overall management and control of the production and business operations, personnel, finances, assets and other matters are executed. See Article 4 of the EIT Law. For a further explanation, see Article 4 and 5, Regulation on the Implementation of the Enterprise Income Tax Law (RIEITL), by the State Council, 6 December 2007. For more introduction, see Jinyan Li and He Huang, 'Tansformation of the Enterprise Income Tax in China: Internationalization and Chinese Innovations' (2008) July Bulletin for International Taxation 276-277.

[479] Article 3 of the EIT Law.

[480] Other types of income include income derived from assets, amounts payable that cannot be settled, collections from accounts receivable that were previously written off as bad debts, income from debt-restructuring, subsidies, damages for breach of contract, exchange gains, etc. See Article 22 of the RIEITL.

other amounts designated as non-taxable by the SAT or the MoF.[481] Exempt income includes interest on state bonds, dividends received from a resident company, dividends that are effectively connected to an establishment or site in China of a non-resident enterprise, and income derived by qualifying non-profit organizations.

Costs, expenses, non-income taxes, losses and other outlays are deductible when calculating taxable income. Costs and expenses include costs of wages, salaries, bonuses and contributions to basic pension plans, basic medical insurance plans, basic unemployment insurance plans, workers' compensation plans, family-planning insurance plans, housing provident funds, and other social insurance plans. Non-deductible items include dividends, taxes paid under the EIT Law, late-payment penalties, fines and penalties, sponsorships, unverified reserves, and other amounts incurred for non-income-producing purposes.[482]

4.6.1.3 Tax rate

The general rate is 25%, which unified the dual-track rates for domestic and foreign enterprises. Before the EIT Law, due to tax incentives for FDI, FIEs and Fes have enjoyed a preferential tax regime compared to domestic Chinese enterprises, meaning that the effective tax rates for them are lower than for domestic enterprises, i.e. 10 percentage points lower to a nominal rate of 33% for domestic enterprises.[483] The 25% tax rate in the EIT Law was considered as an average corporate tax rate and internationally competitive.[484] Thus, even without designated lower tax rates for FIEs or FEs, the unified rate was believed as providing preferential treatment and attracting FDI in tax competition with other countries.

4.6.1.4 Tax incentives

There is a separate chapter in the EIT Law particularly focusing on Chinese tax incentives. The general principle for granting tax incentives is that the state grants tax incentives to industries and projects that are specifically supported and encouraged. The State intended to use tax incentives

[481] Article 26 of the EIT Law.
[482] Li and Huang, 'Tansformation of the Enterprise Income Tax in China: Internationalization and Chinese Innovations' 279.
[483] Li, 'Fundamental Enterprise Income Tax Reform in China: Motivations and Majore Changes' 521-522.
[484] Ibid. In 2007, the average enterprise income tax rate was 28.6% in 159 countries around the world and 26.7% in China's 18 neighboring countries. Thus, the rate of 25% was regarded as conducive to enhancing enterprise competitiveness and attracting foreign investment. See Jin Renqing, former Minister of Finance, Explanation on Draft Enterprise income Tax Law, the full text of the speech in English is available at <www.china-embassy.org/eng/gyzg/t302221.htm> accessed 26 November 2015.

to direct investment towards state-supported industries and projects, which has replaced the former system of region-oriented tax incentives. Compared to the pre-2008 region-oriented tax incentives, the new tax incentives regime was considered to be more industry-oriented, limited geography-based.[485] There were diverse forms of tax incentives such as tax exemptions, tax reductions, reduced tax rates, accelerated depreciation, weighted deductions, etc. Enterprises qualified to enjoy tax incentives include SLEs, high-technology (high-tech) enterprises, and non-profit enterprises. Tax-preferred projects include investments in agriculture and fishing, infrastructure, venture capital, environmental protection and production safety, as well as investments in autonomous regions.[486] The industry-oriented incentives in the EIT Law are aimed at encouraging investments in state-supported industries and projects, such as technological development, environmental protection, energy conservation, production safety, venture capital, agriculture, forestry, animal husbandry, fishery, and infrastructure development.[487] Therefore, for FDI, tax incentives are used to guide the direction of the investment.

4.6.2 Industry-oriented tax incentives

4.6.2.1 High-tech enterprises

To be qualified as high-tech enterprises, there are several conditions to be satisfied.[488] Once an enterprise is identified as a high-tech enterprise, it can receive several types of tax incentives under the EIT Law, including a reduced tax rate of 15%; exemption of income from the transfer of

[485] Andrew Halkyard and Ren Linghui, 'China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis' in Arthur Cockfield (ed), *Globalization and Its Tax Discontents: Tax Policies and International Investments: Essays in Honour of Alex Easson* (Globalization and Its Tax Discontents: Tax Policies and International Investments: Essays in Honour of Alex Easson, University of Toronto Press 2010) 35-59.

[486] Jinyan Li and He Huang, 'Transformation of the Enterprise Income Tax in China: Internationalization and Chinese Innovations' (2008) July Bulletin for International Taxation 276-277.

[487] Jin Renqing, former Minister of Finance, Explanation on Draft Enterprise income Tax Law, the full text of the speech in English is available at <www.china-embassy.org/eng/gyzg/t302221.htm> accessed 26 November 2015.

[488] Article 11, Guokefahuo [2016] No.32, Administrative Measures for Determination of High-tech Enterprises, issued by the Ministry of Science and Technology, the MoF, and the SAT, 29 January 2016 (the 2016 Guidelines). The general conditions: (1) the enterprise must have been registered for over one year; (2) products (services) are within the scope prescribed in the high-tech Sectors Eligible for Key Support from the State; (3) the proportion of R&D expenditures to sales revenue is not lower than a prescribed ratio; (4) the proportion of the revenue derived from high-tech products (services) to the total revenue of the enterprise is not lower than a prescribed ratio; (5) the proportion of the number of research and development personnel to the number of all employees is not lower than a prescribed ratio, etc.

technology;[489] additional deductions for R&D expenses, i.e. 150% of the actual expense is deductible as a current expense or amortized as a capital expenditure;[490] accelerated depreciation; special deductions for eligible investors in high-tech enterprises, for instance, if a venture capital enterprise invests in the shares of a new private small or medium sized high-tech enterprise and holds the shares for two or more years, 70% of the investment may be deductible. The deductions may be carried over to the following years.[491]

In addition, to simplify the procedure of receiving such tax incentives, the SAT confirms that once an enterprise is identified as a high-tech enterprise, it can enjoy corresponding tax incentives without the assessment of the tax administration, but they must keep a report in their administration.[492]

4.6.2.2 Software industry and integrated circuit (IC) industry

After the promulgation of the EIT Law, the government revised the Catalogue for the Guidance of Foreign Investment Enterprises (the Catalogue) to guide the investments in FEs and FIEs.[493] According to the Catalogue, industries for FDI are classified as encouraged, restricted, and prohibited. The main categories of sectors that are encouraged by the Catalogue are (I) agriculture, forestry, animal husbandry and fishery; (II) mining industry; and (III) manufacturing industries. Compared to the investment categories before the EIT Law, the new Catalogue added banking and telecommunications back-office services, software development and related contracting businesses, logistics and outsourcing, venture capital enterprises, intellectual property services, and the manufacturing of key components of new-energy vehicles to the encouraged investment category.

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[489] It was confirmed in the 2016 Guidelines for Identification of High-tech Enterprises that a high-tech enterprise identified under the Guidelines may apply for tax incentives according to the EIT Law, the RIEITL, the Law on the Administration of Tax Collection (LACT), and the detailed rules on the Implementation of the Law on the Administration of Tax Collection. See Article 4 of the 2016 Guidelines. See also Caishui [2010] No. 111, Notice on Related Corporate Income Tax Issues of Resident Enterprise's Technology Transfer, issued by the MoF and the SAT, 31 December 2010.

[490] Detailed rules can be found in Guoshuifa [2008] No.16, the Administration Guidelines for Tax Deductions for Enterprise's R&D Expenses (Tentative), issued by the SAT, 10 December 2008.

[491] Li and Huang, 'Transformation of the Enterprise Income Tax in China: Internationalization and Chinese Innovations' 276-277.

[492] The SAT notice [2015] No.76, Notice on the Issuing of Administrative Regulation of Corporate Tax Incentives, by the SAT, 12 November 2015.

[493] The Catalogue for the Guidance of Foreign Investment Enterprises (amended in 2015), http://www.sdpc.gov.cn/zcfb/zcfbl/201503/t20150313_667332.html.

Following the Catalogue, to promote investment in the encouraged sectors, the MoF and the SAT issued special tax incentives for software industry and integrated circuit (IC) industry.[494] Qualified IC production enterprises can enjoy tax exemptions for the first few years starting from the first profit-making year or a reduced tax rate of 15%.[495]

4.6.2.3 Small and low-profit enterprises (SLEs)

Small and medium sized enterprises (SMEs) are an important power in promoting the state's economic development and market prosperity, especially under the system of a market economy. They are also essential to create employment and to maintain social stability. Moreover, they are pioneers for the promotion of technology.[496] The EIT law has specific tax incentives for small and low-profit enterprises (SLEs). Once an enterprise is identified as a SLE, it enjoys a reduced tax rate of 20%.[497] In order to further support the development of SLEs, the government has consistently expanded the tax incentives. For instance, the threshold for qualification is lowering. The latest tax preference is that, from 1 October 2015 to 31 December 2017, for SLEs whose annual income is lower than 200,000 RMB, the taxable income is calculated as 50% of the annual income and is taxed at the rate of 20%.[498] Compared to the previous threshold of 60,000 RMB,[499] it includes more SLEs to enjoy the preferential tax treatment.

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[494] Guofa [2011] No.4, Notice on the Issuance of Policies on the Further Encouragement on Software Industry and Integrated Circuit Industry, by the State Council, 28 January 2011; Caishui [2012] No.27, Notice on Enterprise Income Tax Policy for the Further Encouragement on Software Industry and Integrated Circuit Industry, by the MoF and the SAT, 20 April 2012; Caishui [2015] No.6, Notice on the Further Encouragement on Software Industry and Integrated Circuit Industry, by the MoF, the SAT, National Development and Reform Commission, and Ministry of Industry and Information Technology, 9 February 2015.

[495] Ibid.

[496] Official answers of the MoF and the SAT to journalists' questions on the enterprise income tax incentives for SLEs, (15 September 2015) <http://www.chinatax.gov.cn/n810219/n810724/c1808384/content.html> accessed 10 December 2015.

[497] Article 92 and 93 of the RIEITL. Conditions for enterprises to be identified as SLEs: (1) for industrial enterprises, the taxable income for the year shall not exceed RMB 300,000, total employees shall not exceed 100, and total assets shall not exceed RMB 30 million; (2) for all other enterprises, the taxable income for the year shall not exceed RMB 300,000, total employees shall not exceed 80, and total assets shall not exceed RMB 10 million.

[498] The degree of the incentive is expanding in the sense that for SLEs whose annual income is between 200,000 and 300,000 RMB, they enjoy the same tax treatment as those enterprises whose annual income is lower than 200,000 RMB. See Caishui [2015] No.34, Notice on Issues Related to Enterprise Income Tax Incentives for Small Low-profit Enterprises, by the MoF and the SAT, 13 March 2015; Caishui [2015] No.99, Notice the Further Expansion of Enterprise Income Tax Incentives for Small and Low-profit Enterprises, by the MoF and the SAT, 2 September 2015.

[499] Caishui [2011] No.117, Notice on issues Related to Enterprise Income Tax Incentives for Small Low-profit Enterprises, by the MoF and the SAT, 29 November 2011.

4.6.2.4 Energy-saving services enterprises

Preferential tax incentives are granted to energy-saving service enterprises who assist customers to implement energy performance contracting projects to save energy. This type of tax incentive serves the objective of environmental protection.

For qualified enterprises, [500] there are tax exemptions for the first three years starting from the first profit-making year and, from the fourth to the sixth year, tax shall be cut half based on the standard 25% enterprise income tax rate. [501]

4.6.3 Regional tax incentives

4.6.3.1 Autonomous regions

(1) Background of autonomous regions

There are 56 officially recognized ethic groups (nationalities) in China. The largest ethnic group is the Han nationality, which constitutes over 90% of the whole population.[502] The rest of the population is identified as comprising minority nationalities, which include the Zhuang nationality, Manchus, Mongols, Tibetans, and Uighurs, etc. A number of areas associated with one or more ethnic minorities are designated as autonomous regions within China. There are five autonomous regions in China, including the Inner Mongolia Autonomous Region, the Xinjiang Uygur Autonomous Region, Guangxi Zhuang Autonomous Region, the Ningxia Hui Autonomous Region, and the Tibet Autonomous Region. Most of these areas are located on the border of China, which makes up over 50% of the whole territory of China. The prosperity of these regions is directly related to China's unification, internal stability, and national defenses. [503] These areas are recognized in the Constitution and are nominally given a number of rights not accorded to other administrative divisions. As stipulated in the Constitution, there are autonomous regions, prefectures, counties, and banners in China.[504]

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[500] Caishui [2010] No.110, Notice on Value Added Tax, Business Tax, and Enterprise Income Tax Policies of the Promotion of Energy-saving Services Industries, by the MoF and the SAT, 30 December 2010. The eligibility includes the enterprise must be an independent legal entity with a registered capital of no less than one million Yuan and can provide diagnostic energy situation, energy project design, financing, renovation, operational management, personal training and other services, etc.

[501] Ibid.

[502] Xiaohui Wu, 'From Assimilation to Autonomy: Realizing Ethnic Minority Rights in China's National Autonomous Regions' (2014) 13 Chinese Journal of International Law 57-58.

[503] June Teufel Dreyer, *China's Forty Millions : Minority Nationalities and National Integration in the People's Republic of China* (Harvard University Press 1976) 377.

[504] Article 94 of the RIEITL. See also the Law of the People's Republic of China on Regional National Autonomy (2001 Amendment), by the Standing Committee of the NPC, 28 February 2001.

As confirmed by the Constitution, regional autonomy is the basic system in China that people of minority nationalities living in concentrated communities enjoy autonomy in that region. In these areas, organs of self-government are established to exercise the power of autonomy.[505] These regions enjoy a wide range of autonomous powers, such as political autonomy,[506] economic autonomy, and language, educational and cultural rights,[507] etc.

With respect to economic autonomy, the organs of self-government of the national autonomous areas have the power of autonomy in administering the finances of their areas. All revenues accruing to the national autonomous areas under the financial system of the state shall be managed and used by the organs of self-government of those areas on their own.[508] Because of their autonomy, they are also granted the discretionary power to reduce or exempt tax on the part of the enterprise income tax payable by an enterprise located in their region.[509] The central government's attitude towards the autonomous regions is rather preferential in such a way that the state provides financial, material and technical assistance to the minority nationalities to help accelerate their economic and cultural development.[510]

The autonomous region system has its historical and geographic origins in China.[511] Before the establishment of the first Chinese Imperial dynasty in 221 B.C. by the Kingdom of Qin,[512] ethnic groups used to live in the regions where they are living today, the borderlands. The Han people resided in most parts of mainland China. Those minority groups were considered "barbarians"

[505] Article 4, Constitution of the People's Republic of China (2004 Amendment).
[506] Constitution guarantees that among the chairman and vice-chairman of the standing committee of the people's congress of an autonomous region, one or more citizens of the nationality or nationalities shall exercise regional autonomy in the area concerned and the administrative head of an autonomous region shall also be a member of the nationality, or of one of the nationalities, exercising regional autonomy. Moreover, the autonomous authorities exercise the same functions and powers of local organs of State, but within the limits of their authority as prescribed by the Constitution. See Article 113 and 114, Constitution of the People's Republic of China (2004 Amendment).
[507] National minorities have the right to use and develop their own languages and freedom to preserve their own customs. In autonomous regions, court hearings should be conducted in their native spoken and written languages. See Article 134, Constitution of the People's Republic of China (2004 Amendment).
[508] Article 117, Constitution of the People's Republic of China (2004 Amendment).
[509] Article 29 of the EIT Law.
[510] Article 122, Constitution of the People's Republic of China (2004 Amendment).
[511] X. Wu, 'From Assimilation to Autonomy: Realizing Ethnic Minority Rights in China's National Autonomous Regions' (2014) 13 Chinese Journal of International Law 55.
[512] The Qin dynasty was the first imperial dynasty of China, lasting from 221 BC to 206 BC. It was formed by the state of Qin who had conquered the other six states. Morris Rossabi, *A History of China* (John Wiley and Sons 2014) 59.

compared to the Han people, as they were considered to be inferior to them in relation to the economy, technology, and culture.[513] Since the Qin dynasty, the Chinese empire started to attract and control the remote territories inhabited by the minority groups via both military forces and cultural assimilation. In order to maintain a central control, the minority's political leaders were allowed to exercise autonomous power in their territory, which was the initiation of the autonomous system.[514] From that time on, the minority groups started to integrate with the Han people by pluralistic forms, thereby accelerating the strengthening of a unified China.

After the establishment of the PRC in 1949, the government had a more tolerant attitude towards national minorities. Domestically, the government hoped to build a unitary multinational country or "one big co-operative family" to contribute to the construction of a socialist state; internationally, the stability of minority areas is crucial for the defense of borders. Geographically, the regions of the ethnic groups take up over a half of China's territory, most of which are border areas, so they have strategic importance for China's defense.[515] When China started the Reform and Opening policy in 1978, the focus shifted to economic development and full implementation of the autonomous region system. At that time, the regions were among the poorest and least-developed but with the richest deposits of natural resources, and therefore an autonomous system was expected to accelerate the economic growth of those regions. Subsequently, the Law of People's Republic of China on Autonomous Regions was passed in 1984 to guarantee the legal rights of those regions.

(2) Tax incentives in autonomous regions

According to Article 29 of the EIT Law, the autonomous authority of a national autonomous region may decide on the reduction or exemption of the local portion of the EIT to be paid by enterprises within the region.[516] Compared to former region-oriented tax incentives, in the EIT Law, the discretion to grant tax incentives has only been delegated to local governments of

[513] Ibid.
[514] Dreyer, *China's Forty Millions : Minority Nationalities and National Integration in the People's Republic of China*.
[515] Colin Mackerras, *China's Minorities : Integration and Modernization in the Twentieth Century* (Oxford University Press 1994) 150-153.
[516] Tax reductions or exemptions decided on by an autonomous prefecture or county shall be subject to approval by the people's government of a province, autonomous region or municipality directly under the central government. See Article 29 of the EIT Law.

autonomous regions, which are historically underdeveloped.[517] Although it is easier for the central government to monitor the implementation of discretionary tax incentives, there are still concerns about the transparency and accountability of the discretion that may lead to another round of sub-national tax competition.[518]

4.6.3.2 Western Development Strategy (WDS)

From 2001 to 2010, the Western Development Strategy was considered to play an effective role in stimulating the economic and social development in the western region.[519] Therefore, after the expiry of the strategy, the central government decided to extend the tax incentives for a new round from 1st January 2011 to 31st December 2020.[520] The Western Development Strategy (WDS) covers the area of 15 regions, which are mainly located in the western part of China, including five autonomous regions. As explained before, these regions are historically less developed than the eastern and central regions, and the disparity between regions is still increasing.

Although the EIT Law abolished most region-oriented tax incentives, these particular tax incentives for Western Development were reserved. The regional disparity still existed and was enlarging, compared to the eastern and central regions of China, despite the fact that it had experienced rapid economic growth due to the 10-year Western Development Strategy support.[521]

To continue encouraging investment in the western region, investment in state-encouraged industries, the regional enterprise income tax rate can be reduced to 15%.[522] Moreover, the scope

[517] Due to the opening process of China to the world economy, the eastern coastal region develops faster than the central and western regions. There is huge regional disparity in China. All the autonomous regions are located in the western or central part of China, thus are less developed even after the Reform and Opening in 1978.

[518] Halkyard and Linghui, 'China's Tax Incentives Regimes for Foreign Direct Investment: an Eassionian Analysis' 28.

[519] The average GDP of western regions increased from 1.8728 trillion Yuan to 5.8257 trillion Yuan from 2001 to 2008, making the average annual growth rate 12%. See China Statistical Yearbook 2001 and 2008, cited by Yucai Xiao, 'The Effect of Tax Preferential Policy and Its Future Direction in Western Development' (2012) 3 Finance and Economics 87 (in Chinese).

[520] Caishui [2011] No.58, Notice of Tax Policy Issues Regarding Further Implementation of the Western Development Strategy, by the MoF, the General Administration of Customs (GAC), and the SAT, July 27, 2011.

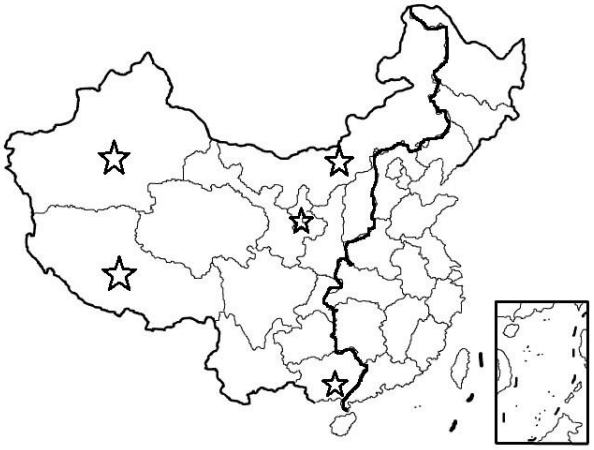
[521] Shenggen Fan, Ravi Kanbur and Xiaobo Zhang, 'China's Regional Disparities: Experience and Policy' (2011) 1 Review of Development Finance 47-56; Huan Zheng and Xingming Fang, 'An Evaluation on the Effects of the Policy of the Great Campaign of Western Development of China in the First 10 Years-Based on the Kuznets Regional Inverted-U Theory' (2013) 12 Chinese Business Review 661-672.

[522] To be qualified for the tax incentive, the main business income of the enterprise shall be more than 70% of the enterprise's overall annual income. The State-encouraged industries are included in Catalog of

of the western region has enlarged, so more regions can enjoy similar tax incentives referring to the western region.[523]

The reasons to implement the WDS are partially similar to the those for autonomous regions, since the autonomous regions are included in the areas for the WDS. There is great disparity between the coast area and the inland region and between the rural and the urban regions in China.[524] Zhang and Zou (2012) identify specific causes for the phenomenon. The opening started from the coastal areas to the inland areas since the 1978 reform, which determined the order for the development. What is more, the central government adopted more urban-biased policies to stimulate economic growth in the eastern part. Additionally, there was more unemployment in less-developed regions caused by the reform of SOEs. Furthermore, tax revenue was transferred from the poor regions to the rich regions during tax competition triggered by fiscal decentralization. Other reasons included the influence of more FDI and export, better public infrastructures, educational opportunities in the coastal regions, and restricted labor migration from the inland to the coastal areas, etc.[525]

In order to control the potential social and political instability derived from the regional inequality, the government launched the WDS to stimulate the development of western China.



Provinces with a star sign:

Autonomous regions

The part left of the black line:
Western regions covered by the WDS

Chart 5

Western Region Encouraged Industries. See Article 2 of the Notice of Tax Policy Issues Regarding Further Implementation of the Western Development Strategy, by the MoF, the GAC, and the SAT, July 27, 2011.

[523] Article 4, ibid.

[524] Fan, Kanbur and Zhang, 'China's Regional Disparities: Experience and Policy'; Chao Li and John Gibson, 'Rising Regional Inequality in China: Fact or Artifact?' (2013) 47 World Development 16; Qinghua Zhang and Heng-fu Zou, 'Regional inequality in contemporary China' (2012) 13 Annals of Economics and Finance 113.

[525] Zhang and Zou, 'Regional inequality in contemporary China'.

4.6.3.3 Comprehensive Experimental Zones (CEZs)

In 2014, new tax incentives were granted to special regions named as comprehensive experimental zones (CEZs) including Hengqin New District in Guangdong (Hengqin), Pingtan Comprehensive Experimental Zones in Fujian (Pingtan), and Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone (Qianhai). They are located next to Macau, Taiwan, and Hong Kong respectively.[526]

Hong Kong and Macao are special administrative regions (SARs) of China because the Qing Government (1644-1912), the predecessor of the People's Republic of China, leased both of them to foreign countries (UK and Portugal). On 1 July 1997 and 20 December 1999, Hong Kong and Macao returned to China but retained their own capitalism systems under the idea of "one country, two systems".[527]

The establishment of the CEZs intended to form a mutual beneficial situation between the mainland and the SARs. On the one hand, the CEZs can provide support for the prosperity of the SARs to enhance the position of Hong Kong as an international financial center and to create diversified opportunities for Macau. Most importantly, the CEZs can compensate for the limited natural resources and labor forces.[528] On the other hand, the CEZ area can benefit tremendously from the SARs, which will create new economic growth points for the Pearl River Delta Region. The ultimate goal is to form a win-win situation for the mainland and the SARs. The establishment

[526] Hengqin is an island located at Zhuhai city in the Guangdong province, which is next to Macau. On 14 August 2009, the State Council approved the General Development Plan of Hengqin to explore a new model of cooperation between Guangdong, Macau, and Hong Kong; Pingtan is also an island in the Fujian province, which is the closest part of Mainland China to Taiwan. Its construction and development will promote the communication and cooperation between Mainland China and Taiwan. The National Development and Reform Commission issued the Overall Development Plan of Pingtan Comprehensive Experimental Zone in November 2011; Qianhai, located in Shenzhen SEZ, is close to Hong Kong and is also a combination point for Guangdong-Shenzhen-Hong Kong development area. In 2012, the State Council approved the proposal to further develop the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, See Guohan [2012] No.58, Reply of the State Council on the Relevant Policies Supporting the Development and Opening-up of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, by the State Council, 27 June 2012.

[527] It is a constitutional principle formulated by Deng Xiaoping. He suggested that there would be only one China, but distinct Chinese regions such as Hong Kong, Macao, and Taiwan could retain their own capitalist economic and political systems, while the rest of China uses the socialist system.

[528] Guohan [2012] No.58, Reply of the State Council on the Relevant Policies Supporting the Development and Opening-up of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, by the State Council, 27 June 2012.

of Pingtan CEZ exhibits the government's ambition to intensify communication and cooperation with Taiwan.[529]

Considering the special location advantages of the three comprehensive experimental zones, they were authorized to grant more preferential tax incentives even than SEZs, including a 15% tax rate for enterprises investing in the state's encouraged industries in the three zones starting from 1st January 2014 to 31st December 2020.[530] The prosperity of these regions has not only economic effects but also political considerations for China. On the one hand, new incentives of the regions not only can promote the development of the regions themselves, but they can also provide more services for the development of Hong Kong, Macao, and Taiwan, thus achieving the expected "win-win" results. On the other hand, taking into account the special political positions of the three islands with China, tax incentives are considered to be reasonable instruments to promote the prosperity of the new zones and to maintain political stability of the areas.

4.6.3.4 Free Trade Zones (FTZ)

A free trade zone (FTZ) is a geographic area within one country's territory in which the import or export of goods is free from customs' intervention. It can be considered as "outside the customs territory but within one country's territory".[531] There are four FTZs in China at present, including Shanghai FTZ, Guangdong FTZ, Tianjin FTZ, and Fujian FTZ.[532] The main objectives of the FTZs

[529] Taiwan has been separated for the mainland since 1949, but the PRC intends to implement the policy of "one country, two systems" to Taiwan as well. Roderick MacFarquhar and John K. Fairbank, *The Cambridge History of China: The People's Republic, Part 2: Revolutions within the Chinese Revolution, 1966-1982*, vol 15 (Cambridge University Press 1991) 813-874.

[530] Caishui [2014] No.26, Notice on Enterprise Income Tax Incentives and Catalogue for Guangdong Hengqin New District, Pingtan Comprehensive Experimental Zones, and Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, by the MoF and the SAT, 7 May 2014.

[531] There are different forms of free trade zones, such as foreign trade zones, duty free zones, export processing zones, and special economic zones, etc. See Raul A. Torres, 'Free Zones and the World Trade Organization Agreement on Subsidies and Countervailing Measures' (2007) 2 Global Trade and Customs Journal 217.

[532] Shanghai FTZ was the first FTZ in China, which was established in 2013. In 2015, the central government announced the approval of the other three FTZs, which were located in the province of Guangdong, Fujian, and Tianjin municipality. Guangdong FTZ contains the area of Hengqin CEZ, and Fujian FTZ contains the area of Pingtan CEZ. See Guofa [2013] No.38, Notice on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 18 September 2013; Guofa [2015] No.18, Notice on the Framework Plan for the China (Guangdong) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.19, Notice on the Framework Plan for the China (Tianjin) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.20, Notice on the Framework Plan for the China (Fujian) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.21, Notice on the

are to reduce administrative interventions in those trial areas, ease restrictions on investments, further open up the financial system, and internationalize the currency to boost shipping, logistics, and commerce, etc.[533] It is regarded as a major reform step for China to further integrate into the world economy through liberalization and to provide more market access in different sectors.[534] To achieve the objectives, a series of reforms are implemented in the FTZs, including a high level of legal autonomy, expanded opening-up of service industries, new mode of administrative approval for FDI, and the innovation of tax policies, etc.[535] Compared to the beginning stage of the Reform and Opening in 1978, the background of the new reform is different. The establishment of SEZs in the 1980s were to initiate the opening of China to the world economy, the attraction of FDI was essential to draw new capital, technology, and talents to stimulate economic growth. Therefore, a large number of tax incentives were granted to FIEs in those SEZs. Actually they distorted fair competition in the market. In contrast, the context of the FTZ is that China does not have to rely on large quantities of tax incentives to attract FDI, but it hopes to carry out reforms to upgrade its economic structure and release more productivity forces.[536] Thus, the FTZ is a trial to liberalize the market further and gain experiences that can be repeated spread over the country. In summary, the emphasis of the reform is not on tax incentives but on further opening the market.

Further Implementation of the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 8 April 2015.

[533] For instance, as stated in the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, the overall objectives of the FTZ were that "the FTZ shall accelerate the transformation of government functions, actively promote the expansion of opening-up of the service industry and reform of the foreign investment management system, vigorously develop the central economy and new trade forms, accelerate the exploration of convertibility under capital accounts and full opening-up of the financial service industry, explore the establishment of a categorized regulation mode based on the status of goods, strive to form a policy support system promoting investment and innovation, pay particular attention to cultivating an internationalized and regulated business environment, strive to become a pilot free trade zone meeting international standards and featuring investment and trade facilitation, free convertibility of currencies, efficient and convenient regulation, and satisfactory legal environment, and explore new ideas and new channels for furthering opening-up and reform in China and better serving the whole country." Guofa [2013] No.38, Notice on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 18 September 2013.

[534] Zheng Wan and others, 'Policy and Politics behind Shanghai's Free Trade Zone Program' (2014) 34 Journal of Transport Geography 1.

[535] Ibid.

[536] Jianwen Liu, 'On the Development of Shanghai Free Trade Zone Reform in the Perspective of the Rule of Fiscal and Tax Law', (2014) 3 Legal Forum 88-89 (in Chinese); Hongmei Sun and Mengyin Guo, Research on the Feasibility of Levying 15% Enterprise Income Tax in the Chine (Shanghai) Free Trade Zone, (2014) 27 China Market 94 (in Chinese).

However, the granting of tax incentives, on the contrary, just demonstrates the government's intervention in the market.

There are certain tax incentives only granted in the FTZs, so the focus of the FTZ policies is more on the opening-up of financial sectors, and thus the tax incentives are not as preferential as they were expected to be.[537] A significant reason is that the central government hopes that measures implemented in the FTZ can form a replicable experience to be implemented by other regions. If the central government grants too much preferential tax treatment in the FTZ, it will be difficult to spread them widely. Most importantly, it goes against the object of the new round of the reform, namely, to adjust the relationship between the government and the market towards a more market-oriented economy with the rule of law.[538] In the official documents, it is also emphasized that tax policies in the FTZs should not lead to base erosion and profit shifting according to international customs.[539]

Forms of tax incentives in the FTZs include tax deferral, same treatment of export tax rebate, preferential import VAT policies, and a choice of paying the import duties on the inputs or paying the duties for the finished product. Actually, there is only one direct tax incentive; the others are

[537] Before the issuing of the Frame Work Plan for the China (Shanghai) Free Trade Zone, there were discussions on granting a lower enterprise income tax rate of 15% for enterprises established in the FTZ, which was implemented in those comprehensive experimental zones. However, the Frame Work Plan tried to avoid forming an unleveled playing field (tax marsh) compared to other regions that can distort fair competition in the market. The concept of "tax marsh" was used by the present Minister of Finance Lou Jiwei in an explanation on the ideas of deepening the fiscal reform after the 18th National Congress of the CCP. See Jianwen Liu, 'On the Development of Shanghai Free Trade Zone Reform in the Perspective of the Rule of Fiscal and Tax Law' (2014) 3 Legal Forum 88-89 (in Chinese); Hongmei Sun and Mengyin Guo, 'Research on the Feasibility of Levying 15% Enterprise Income Tax in the China (Shanghai) Free Trade Zone' (2014) 27 China Market 94 (in Chinese).

[538] Liu, 'On the Development of Shanghai Free Trade Zone Reform in the Perspective of the Rule of Fiscal and Tax Law' 88-89.

[539] Guofa [2013] No.38, Notice on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 18 September 2013; Guofa [2015] No.18, Notice on the Framework Plan for the China (Guangdong) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.19, Notice on the Framework Plan for the China (Tianjin) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.20, Notice on the Framework Plan for the China (Fujian) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.21, Notice on the Further Implementation of the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 8 April 2015.

indirect tax incentives related to import or export, because the prior function of the FTZ is a free trade port for logistics.[540]

4.6.4 Matrix of specific direct tax incentives

Subject	Highlights of the incentives	Eligibility
High-tech enterprises	15% CIT rate; exemption of income from the transfer of technology; additional deduction for R&D expenses; accelerated depreciation; special deductions for eligible investors in high-tech enterprises, etc.	(1) products (services) are within the scope prescribed in the High-tech Sectors Eligible for Key Support from the state; (2) the proportion of R&D expenditures to sales revenue is not lower than a prescribed ratio; (3) the proportion of the revenue derived from hi-tech products (services) to the total revenue of the enterprise is not lower than a prescribed ratio; (4) the proportion of the number of research and development personnel to the number of all employees is not lower than a prescribed ratio; (5) other conditions
Software industry and integrated circuit (IC) industry	Tax exemptions for the first few years starting from the first profit-making year; or 15% CIT rate	IC lines the width of which is less than 0.8 microns (inclusive), have been identified before 31st December 2017; IC lines the width of which is less than 0.25 microns or the investment amount is over 8 billion RMB; Key software enterprises and IC design enterprises included in the state planning
Energy-saving services enterprises	Tax exemptions for the first three years starting from the first profit-making year, and from the fourth to the sixth year, CIT shall be cut half based on the 25% CIT rate	Independent legal entity with a registered capital of no less than one million yuan and can provide diagnostic energy situation, energy project design, financing, renovation, operational management, personal training and other services
Small and low profit	1. 20% CIT rate	1. (1) Industrial enterprises: the taxable income for the year shall not exceed RMB 300,000, total

[540] Guofa [2013] No.38, Notice on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 18 September 2013. The other FTZs may imitate the tax incentives that have been implemented in Shanghai FTZ.

enterprises (SLEs)	2. The taxable income was calculated as 50% of the annual income and 20% CIT rate	employees shall not exceed 100, and total assets shall not exceed RMB 30 million; (2) Other enterprises: the taxable income for the year shall not exceed RMB 300,000, total employees shall not exceed 80, and total assets shall not exceed RMB10 million. 2. Until 31st December 2017 The annual income is lower than 300,000 RMB
Autonomous regions	May decide to reduce or exempt tax on the part of the enterprise income tax payable by an enterprise located at the said region	Qualified autonomous regions
Western Development Strategy (WDS)	15% CIT rate until 31st December 2020	Engaging in a wide scope of encouraged industries (e.g. agriculture, services, manufacturing, natural resources, public infrastructure, IT, etc.) which are set out in various catalogues to develop the West of China
Comprehensive experimental zones (CEZs): Hengqin, Pingtan,Qianhai	15% CIT rate until 31st December 2020	State-encouraged industries, including, modern logistics, information service, technology service, and cultural and creative industries, etc.
Pilot Free Trade Zones (FTZs)	Enterprise income tax paid by installments over five years	On the appraised asset appreciation arising from external investment of non-monetary assets and other asset restructurings

4.6.5 Conclusion

Tax incentives in the EIT Law demonstrate China's intention to promote the development of higher value-added sectors, such as high and new technology, high-end manufacturing, environmental protection industries, etc.[541] In addition, it also pays more attention to the disparity between regions, thereby resulting in regional tax incentives for less developed regions, including autonomous regions and western regions. The tax incentives in the CEZs and FTZs serve not only China's policy goals of promoting business activities in these areas but also the further opening up

[541] Suwina Cheng and Shanshan Shi, 'The Impact of New Income Tax Law on Foreign Invested Enterprises in China' (2012) January-February Internatinal Tax Journal 24.

of the market to the world economy. As summarized by some authors, "China intends to use foreign investment rather than be used by foreign investors".[542]

4.7 The present value-added tax (VAT) incentives

4.7.1 Overview of the VAT system in China

The current Chinese indirect taxes, levied on turnovers of goods and services, include three main types of taxes: value-added tax (VAT), business tax (BT), and consumption tax. Compared to direct taxes, indirect taxes are the main tax revenue sources in China.[543]

Value-added tax (VAT) was introduced in China in 1984 as a tax for a small number of manufactured goods.[544] The current VAT system originated from 1994.[545] It applied to the sale of all goods (except for intangible and immovable property), and the provision of processing, repair and replacement services. Compared to VAT systems in other countries, the VAT system in China does not cover all service areas. Other services, transfers of intangibles and immovable properties were taxed as BT.[546]

However, the current VAT system is under reform, which aims to transform items levied as BT to VAT. From 1 May 2016, the items that were previously subject to BT are now subject to VAT, which covers most service industries, including architecture, real estate, finance, etc. The transfer of intangibles and immovable properties will be subject to VAT as well. [547]

There are two types of taxable persons in the VAT system according to the size of their business operations and the sophistication of their accounting systems, namely regular taxpayers and small-scale taxpayers.[548] Taxes are levied on regular taxpayers based on a regular computation method

[542] Ibid.
[543] According to China Statistical Yearbook (2015). The overall tax revenue of China in 2014 was 119175.31 billion Yuan, tax revenue from VAT was 30855.36 billion Yuan, and from business tax was 17781.73 billion Yuan. Indirect taxes have taken 40.81% of the overall tax revenue in 2014.
[544] Regulation on Value Added Tax (Draft), by the State Council, 18 September 1984 (expired).
[545] Interim Regulation of the People's Republic of China on Value Added Tax (Interim Regulation on VAT), by the State Council, No.134, 13 December 1993, revised by the State Council Order No. 666, 6 February 2016.
[546] Interim Regulation of the People's Republic of China on Business Tax (Interim Regulation on BT), by the State Council, No.136, 13 December 1993, revised by the State Council Order No. 540, 10 November 2008.
[547] Caishui [2016] No.36, Notice on Completely Promoting the Transformation of Business Tax to Value Added Tax Pilot, by the MoF and the SAT, 23 March 2016.
[548] Article 3, the Notice on Completely Promoting the Transformation of Business Tax to Value Added Tax Pilot (2016); Article 11, 12 of the Interim Regulation on VAT.

that deducts input VAT from output VAT..[549] In contrast, tax is levied on small-scale taxpayers based on a simplified computation method at a lower tax rate and they may not deduct the input VAT or issue VAT invoices themselves to purchasers.[550]

4.7.1.1 BT transformed into VAT

Since 1984, VAT has been separated from BT when it is first levied. Until the VAT reform in 2009, BT existed as an indirect tax imposed on the provision of services, the transfer of intangible property and the supply of immovable property.

However, the problems stemmed from the separation of VAT and BT so that a reform of the BT to VAT was implemented. The main problem was double taxation. BT was still a cascading tax that meant that the tax imposed on inputs could not be deducted from the tax imposed on outputs, but the taxes were collected at each stage of process of production and distribution.[551] The double taxation problem also hindered the development of service industries covered by BT. [552] However, in comparison with developed countries, the ratio was still low. In order to stimulate economic growth and upgrade the industrial structure, the importance of promoting service industries was highlighted. The reform of the BT could play a significant role.[553]

The main objective of transforming BT to VAT was to solve the problem of double taxation in most service industries and to further stimulate the development of those industries. [554] Consequently, a new round of VAT reform has been implemented since 2012 in Shanghai, extending the scope of VAT to transportation and modern service industries that were previously subject to BT. Under this reform, VAT would be passed on to customers, after the input VAT is deducted from the output VAT in those pilot industries. For small-scale taxpayers, a lower tax rate was still applicable, which was generally lower than the corresponding BT rate.[555] The reform was

[549] Article 4, 5, 6, and 7 of Provisional Regulations on VAT.
[550] Article 18, 19 of the Notice on Completely Promoting the Transformation of Business Tax to Value Added Tax Pilot (2016).
[551] A cascading turnover tax is imposed every time that goods are transferred in the process of production and distribution to the final consumer. It cannot be reclaimed by the purchaser and therefore the tax component of the price of goods becomes larger and larger the more stages there are between producer and consumer, with obvious distortionary effects between highly integrated enterprises and other enterprises. Schenk and Oldman, *Value Added Tax-A Comparative Approach* 3.
[552] China Statistical Yearbook (2012).
[553] Wei Cui, 'Business Tax: China's Quasi-VAT' (2009) July/August International VAT Monitor 294-295.
[554] Report of the MoF and the SAT's Officials' answers to Journalists' Questions on BT to VAT Pilot Program, 17 November 2011.
[555] Peter Law, 'The pilot value added tax reform' (2012) September/October Asia-Pacific Tax Bulletin 374.

aimed at reducing the double taxation burden under the BT regime and promoting the export of services, thereby accelerating the development of service industries in China.[556] Between 2012 and 2015, the transformation gradually expanded to the whole nation on a step-by-step basis.[557] Subsequently, in 2016, all the items that are subject to BT are to be subject to VAT.

The substantial benefit of the reform is the reduction of tax burden for taxpayers since the input VAT can be deducted compared to the previous BT system. Moreover, small and medium sized enterprises' tax burdens are lower even when they are treated as small-scale taxpayers.[558]

4.7.1.2 Export VAT refund

As for exports, like many other countries, China adopts zero rating for exported goods, which means that VAT imposed on goods should be refunded at the time of exportation.[559] The rationale behind this is the destination principle and neutrality principle that personal consumption should be taxed in the country of consumption[560] and goods should enter the international market without the distortion of tax.[561]

However, a zero rate is difficult to operate in China. Normally, neutral refunds should be equal to the VAT paid on the exported goods, but China has a partial refund system, with a refund rate less than or at most equal to the collection rate.[562] For different types of products, the refund rates are different, which results in less or deferred export refunds than what taxpayers could expect.[563] Additionally, the government frequently adjusted the refund rates according to the changes in international trade, such as trade conflicts with other nations. As a result, the government treated VAT export refunds as incentives to encourage or discourage trade activities in various sectors.[564]

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[556] Ibid.
[557] Wei Cui, 'China's Business-Tax-To-VAT Reform: An Interim Assessment' (2014) 5 British Tax Review 617.
[558] The VAT rate for small-scale taxpayers is 3%, which is lower than the corresponding BT rate.
[559] Article 15 (4) the Notice on Completely Promoting the Transformation of Business Tax to Value Added Tax Pilot (2016).
[560] Schenk and Oldman, *Value Added Tax-A Comparative Approach* 35.
[561] James Mirrlees and others, *Tax By Design: The Mirrlees Review* (Oxford University Press 2011) 33-35.
[562] There are several export refund rates, such as 17%, 13%, 11%, 8%, and 5% for different types of products. See Xuepeng Liu, Huimin Shi, and Michael J. Ferrantino, Tax Evasion through Trade Intermediation: Evidence from Chinese Exporters (August 12, 2014). Available at SSRN: http://ssrn.com/abstract=2494054.
[563] J. Whalley and L. Wang, 'Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus' (2007) Working paper series .
[564] Xu Yan, 'Reforming Value Added Tax in Mainland China: A Comparison with the EU' (2011) 20 Revenue Law Journal 4 16.

From the 1994 tax reform to 2009, the refund tax rates were adjusted eleven times to serve the government's macro control of the economy.[565]

4.7.2 VAT incentives

4.7.2.1 Methods of VAT incentives

(1) Exemptions

The first frequently used VAT incentive is exemption. It means that the output VAT is exempted, but the input tax is not creditable.[566] The exemption method is aimed at reducing tax burdens for the seller or reducing prices for consumers, but it is likely to cause the opposite effects when granted at different stages of the VAT chain.

As a type of tax incentive, exemptions are granted for particular reasons.[567] The main reason is that, for some transactions, the output is difficult or impractical to tax. In the case of small-sized taxpayers, especially when the number is very large, costs for administering the output can be extremely high, and therefore exemption becomes a realistic solution. From the perspective of the tax authority, with exemption they do not need to monitor the output tax or the recovery of input tax, which is less costly.[568]

However, considering the effects of exemptions, the disadvantages shall also be taken into account. As analyzed by Ebrill, Keen, Bodin, and Summers (2001), exemptions cannot always reduce the price for consumers.[569] If the exemption is granted prior to the final consumption, it can reduce tax for the seller because the value added at the final stage is not taxed, thus resulting in revenue loss. Nevertheless, instead of reducing prices for consumers or revenue for the government, exemptions break the VAT chain when they are granted in the intermediate stage, and they actually increase consumer prices and VAT revenue over the amounts that would occur if those items were taxable.[570] The cascading effects of tax on inputs lead to the result that "the price charged by downstream firms using the exempt item rises in order to cover their increased costs, so the tax on

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[565] The Budget Committee of China's National People's Chinese Budget Committe of the NPC, *A Comparative Study of the Legal System of VAT* (China Democracy and Legal System Press 2010) 143-146.
[566] Liam P Ebrill, *The Modern VAT* (International Monetary Fund 2001) 83.
[567] Ibid 90-91; Schenk and Oldman, *Value Added Tax-A Comparative Approach* 268-270; the Budget Committee of China's National People's Chinese Budget Committe of the NPC, *A Comparative Study of the Legal System of VAT* 123-124.
[568] Ibid.
[569] Ibid.
[570] Schenk and Oldman, *Value Added Tax-A Comparative Approach* 268-270.

output downstream increases".[571] In summary, the value added prior to the exempt stage is taxed more than once.

In summary, "exemptions are abhorrent to both the logic and the functioning" of the VAT, as commented by some economists,[572] because they might undermine a VAT and distort the order of the economy if they are not granted in the final stage but in the intermediate stage. Therefore, the effectiveness of VAT exemptions is still debatable.

(2) Collect and return

Another important way of granting tax incentives is called "collect and return", i.e. first collect and afterwards return (xian zheng hou fan) and immediately collect and immediately return (ji zheng ji tui).[573] The VAT collected will be returned to the regular taxpayer afterwards. The effect of this "collect and return" is equal to a partial or complete tax exemption, which is similar to subsidies to taxpayers by the government in order to achieve policy goals.[574]

Collect and return is a special method for granting tax incentives in China. Compared to exemptions, it does not break the VAT chain with non-recoverable input taxes. Although it is different from zero rate, taxpayers indeed pay less taxes. Normally, this kind of VAT incentive is used to support certain industries or enterprises.

4.7.2.2 Specific VAT incentives

From the perspective of an enterprise, there are different categories of VAT incentives to enjoy. Similar to direct tax incentives, they are classified by their specificity and the source of the incentives is mainly the SAT's inventory.

(1) Industry-oriented VAT incentives

a. Software industry

A regular taxpayer who sells self-developed software products, after being taxed at 17% VAT, the actual VAT burden which surpasses 3% will be granted the incentive of immediate taxation and immediate refund.[575] It means that the taxpayer could get a refund of 14% VAT that was levied.

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[571] Ebrill, *The Modern VAT* 85.
[572] Ibid 100.
[573] Wei Cui and Alan Wu, 'The Chinese VAT' in Michael Lang (ed), *the Future of Indirect Taxation: Recent Trends in VAT and GST Systems around the World* (the Future of Indirect Taxation: Recent Trends in VAT and GST Systems around the World, Kluwer Law International 2012) 179-180.
[574] Ibid.
[575] Article 1, Caishui [2011] No. 100, Notice on VAT Policies for Software Products, by the MoF and the SAT, 13th October 2011.

In addition, if a regular taxpayer sells imported software products after the localization transformation, the product can enjoy the incentive of immediate taxation and immediate refund.[576]

b. Animation industry

Animation enterprises, being regular taxpayers who sell self-developed software products, after being taxed at 17% VAT, will be granted the incentive of immediate taxation and immediate refund of the amount of the actual VAT burden which surpasses 3%.[577] As a result, taxpayers will get a 14% refund of the VAT that has been paid.

c. Energy-saving service enterprises

Energy saving enterprises who implement energy performance contracting and enterprises that transfer the goods subject to VAT to energy consumption enterprises are exempted from VAT.[578]

d. Small and low-profit enterprises (SLEs)

In order to further support the development of small and low profit enterprises (SLEs), VAT exemptions were granted to SLEs. If a SLE's monthly sale is lower than 20,000 RMB, it can enjoy the VAT exemption as a small-scale taxpayer. Before 31st December 2017, if a SLE's monthly sale is between 20,000 and 30,000 RMB, it can enjoy the VAT exemption as a small-scale taxpayer.[579] These incentives were promulgated together with the other CIT incentives that were aimed at reducing the tax burdens of SLEs and stimulating their expansion.[580]

(2) Regional VAT incentives

Under the Western Development Strategy, VAT is exempted for imported self-used equipment within the lump sum investment in state-encouraged industries, encouraged industries for FDI, and projects of competitive industries.[581]

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[576] Article 2 Ibid. Localization transformation means redesign, improvement, conversion of the products, etc. However, purely transforming the imported software products into Chinese characters are not included.
[577] Article 1, Caishui [2013] No.98, Notice on Value Added Tax and Business Tax on the Animation Industry, by the MoF and the SAT, 28 November 2013. The identification of animation software refers to Notice on VAT Policies for Software Products (Caishui [2011] No.100). The tax incentive is valid from 1st January 2013 to 31st December 2017.
[578] Article 1 and 2, Caishui [2010] No.110, Notice on Value Added Tax, Business Tax, and Corporate Income Tax Policies for the Promotion of Energy Saving Industries.
[579] Notice on Completely Promoting the Transformation of Business Tax to Value Added Tax Pilot (2016); Caishui [2014] No.71, Notice on Value Added Tax and Business Tax Policies on Further Support for Small and Low Profit Enterprises.
[580] Ibid.
[581] Caishui [2011] No.58, Notice of Tax Policy Issues Regarding Further Implementation of the Western Development Strategy, by the MoF, the GAC, and the SAT, 27 July 2011.

Enterprises located in Comprehensive Experimental Zones (Hengqin and Pingtan) also enjoy a VAT exemption for the income from selling goods among enterprises within the CEZs.[582]

In Foreign Trade Zones (FTZs), financial leasing enterprises registered in the FTZ shall be covered by the pilot program of export tax rebates for finance leasing; necessary goods imported by production enterprises and producer service enterprises shall be exempted from import tax; enterprises can choose to pay tax according to the imported materials or parts or according to the actual inspection declaration status.[583]

4.7.2.3 Matrix of specific VAT incentives

Subject	Eligibility	Methods of VAT incentives
Software industry	1. A regular taxpayer who sells the self-developed software products, after being taxed at 17% VAT, will enjoy a refund of the actual VAT burden that surpasses 3% (14% refund); 2. Import VAT exemption for imported self-used production materials and consumables	1. Immediate taxation and immediate refund; 2. Exemption of import VAT
Animation enterprises	1. A regular taxpayer who sells the self-developed software products, after being taxed at 17% VAT, will enjoy a refund of the actual VAT burden that surpasses 3% (14% refund); 2. Products which must be imported can enjoy an exemption for import tariffs and import VAT	1. Immediate taxation and immediate refund; 2. Exemption of import VAT

[582] Caishui [2014] No.51, Notice on VAT and Consumption Tax Policy in Hengqin and Pingtan, by the MoF, the GAC, and the SAT, 11 June 2014.

[583] Guofa [2013] No.38, Notice on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 18 September 2013; Guofa [2015] No.18, Notice on the Framework Plan for the China (Guangdong) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.19, Notice on the Framework Plan for the China (Tianjin) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.20, Notice on the Framework Plan for the China (Fujian) Pilot Free Trade Zone, by the State Council, 8 April 2015; Guofa [2015] No.21, Notice on the Further Implementation of the Framework Plan for the China (Shanghai) Pilot Free Trade Zone, by the State Council, 8 April 2015.

Small and low profit enterprises (SLEs)	1. The monthly sales of a SLE is below 20,000 RMB 2. Before 31st December 2017, the monthly sales of a SLE is between 20,000 to 30,000 RMB	Exemption
Energy-saving services enterprises	Qualified energy-saving service enterprises implement energy performance contracting projects and transfer the VAT taxable goods to energy consumption enterprises	Exemption
Western Development Strategy	Imported self-used equipment within the lump sum investment in state-encouraged industries, encouraged industries for FDI, and projects of competitive industries;	Exemption of import VAT
Comprehensive Experimental Zones (Hengqin and Pingtan)	The income from selling goods among enterprises within the CEZs	Exemption
Pilot Free Trade Zones	Necessary goods imported by production enterprises and producer service enterprises	Exemption of import VAT

4.7.3 Conclusion

The present VAT incentives reflect the government's support for the development of certain industries and regions. Compared to direct tax incentives, the government does not grant many VAT incentives to specific enterprises or regions. The industries and regions that enjoy specific VAT incentives are those state-supported enterprises and regions, which also enjoy direct tax incentives. In the context of the transformation of BT to VAT, a modern VAT system is to be established in China. In order to maintain a complete VAT chain, the adoption of VAT incentives to achieve governmental goals does not seem to be sound. The aim of VAT incentives is to reduce certain taxpayers' burdens for particular objectives. However, VAT exemptions in different stages of the chain have different effects, which would not necessarily lead to the reduction of tax and would even result in a heavier tax burden due to exemptions in the intermediate stage.

4.8 Conclusion

This chapter introduced Chinese tax incentives, in mainly two parts. The first part provided a chronological review on the evolution of direct tax incentives in China from the establishment of the PRC until the promulgation of the EIT Law. The historical review presented the "rise and fall" of tax incentives for FDI in China. Based on this knowledge, the chapter subsequently established an internal benchmark for the evaluation of China's granting of tax incentives, namely, the creation of a level playing field in the domestic Chinese market. This benchmark was established in the context of China's socialist market economy. There are differences and similarities between China's socialist market economy system and the western market economy system. The key is the relationship between the state and the market. In China, the market operates under the framework of the state and the state has a greater intervention into the market. As state ownership is the leading force of the economy, there is limited access for private ownership in certain areas. However, the similarities implicate that the basic market rules still should be applicable in China's market. Thus, to maintain efficiency and equity in the market, it is necessary to create a level playing field for competition. The content of the level playing field actually shares the same essences with the external benchmark and it should be interpreted according to the principle of equality and the principle of proportionality. Thus, the level playing field in China should take into account regional disparities and the imbalanced development of industries. This internal benchmark offers a foundation for a further evaluation of the Chinese tax incentives.

The second part analyzed the present direct tax incentives and VAT incentives in China. They are classified according to the criteria of industrial and regional specificity, which is the main standard to identify a subsidy in the ASCM of the WTO or a State aid under EU State aid law. All of the incentives are sourced from official laws, regulations, and circulars issued by the government. The current direct tax incentives, mainly corporate tax incentives, focus on high-tech industries, SLEs, environmental friendly projects, and specific regions. The VAT incentives are analyzed under the background of the reform of establishing a modern VAT system in China, i.e. transforming BT to VAT. The reform is still underway. The current VAT incentives have the same focus with corporate tax incentives, and therefore those specific industries and regions enjoy both corporate tax and VAT incentives.

The overview of the present direct and indirect tax incentives in China provides a further insight into China's attitude towards the granting of tax incentives by concentrating on different industries

and regions. Reforms and changes to tax incentives not only promote the economic and social development in China, but they also demonstrate the trend to integrate into the world economy. However, whether or not these incentives satisfy the WTO's subsidy rules still have to be tested. A comparative testing under EU State aid law may shed light on the application of the WTO's standard in China as well.

Chapter 5 Testing Chinese Tax Incentives against the ASCM and EU State Aid Law

5.1 Introduction

After the accession to the WTO, China faced an increasing number of international trade disputes with other Members in the area of subsidies and countervailing measures. In the past ten years, China became the country facing the biggest number of countervailing investigations in the world.[584] Since 2004, when Canada launched the first countervailing investigation against China, more and more Members in the WTO adapted the subsidy rules to solve trade disputes with China.[585] Countervailing measures, which are a seldom-used method for solving international trade disputes, are becoming the main means for Members in the WTO to deal with trade disputes with China.

Among all the countervailing investigations towards China, the main complaints were Chinese tax incentives such as specific tax reductions and exemptions, or specific tax preferences related to exports or imports. The first case on Chinese tax incentives in the WTO was brought by the United States in 2004 on China's preferential value-added tax (VAT) for domestically-produced or designed integrated circuits.[586] In 2007, the United States requested consultations in the WTO's Dispute Settlement Body (DSB) in another case on certain Chinese measures granting refunds, reductions or exemptions from taxes.[587] Subsequently, the European Union also joined the group, in the coated fine paper dispute of April 2010, in which the European Commission claimed that Chinese tax incentives constituted subsidies under the ASCM in the WTO law.[588] Therefore, it is

[584] Until 31st December 2014, China had faced 90 countervailing investigations: 46 were from the US, 20 were from Canada, 10 were from Australia, 9 were from the EU, 2 were from India, 1 was from Mexico, and 1 was from South Africa, and 1 was from Egypt. See <http://www.wto.org/english/tratop_e/scm_e/scm_e.htm, Subsidies and Countervailing Measures Gateway, Statistics on subsidies and countervailing measures, countervailing initiations: reporting Member vs exporting country, 01/01/1995-31/12/2014> accessed 20 November 2015. See also Appendix I.

[585] Canada was the first country that started a countervailing investigation against China. The first investigation was launched on 13th April 2004 on the product of self-standing barbeques for outdoor use. It was a combined countervailing and anti-dumping investigation. For more information, see <www.cbsa.gc.ca> (Canada Border Service Agency): Anti-dumping and Countervailing-Investigations, accessed 20 November 2015.

[586] WT/DS309/1, China-Value-Added Tax on Integrated Circuits, 23 March 2004, Panel Report.

[587] WT/DS358/1, China-Taxes, 7 February 2007.

[588] On 17th April 2010, the European Union also joined the trend of investigating subsidies from China, on the product of coated fine paper. See Notice of Initiation of An Anti-subsidy Proceeding Concerning Imports of Coated Fine Paper Originating in the People's Republic of China [2010] OJ C99/13.

important to examine the relationship between Chinese tax incentives and subsidy rules in the WTO and to check whether or not certain Chinese tax incentives constitute subsidies under the WTO agreements. Furthermore, it contributes to evaluating the impacts of certain Chinese tax incentives on fair competition in the international trade domain. Considering China's rapid development in the world economy, it is also significant to understand China's attitude towards those tax incentives, the rationale behind the granting of them, and the position of China in the international trade.

On the other hand, a comparative analysis from the perspective of EU State aid law can shed some light on the interactions between the WTO's regulation of subsidies and China's attitude towards tax incentives. This chapter conducts a hypothetical analysis on the application of the State aid rules to Chinese tax incentives. The aim of the comparative testing is to find some inspirations for both Chinese tax incentives and the WTO's subsidy rules from the reference to EU State aid law. Therefore, the conclusion of the hypothetical testing is not necessarily absolute, since China indeed is not an EU Member State. Nevertheless, the reality provides an example for the feasibility of the comparative testing. The EU concluded a Free Trade Agreement (FTA) with Korea in 2009.[589] It is the EU's first FTA with a trading partner in Asia that has included comprehensive and enforceable subsidy rules to deal with trade disputes via a bilateral agreement. The FTA includes strong competition rules to safeguard fair competition.[590] With respect to subsidies, the bilateral FTA is regarded as an expansion of State aid rules to a third country outside the EU.[591] A substantial objective of the FTA is to create free and open trade between the two partners by introducing more comprehensive disciplines on subsidies. It also provides a new model under the current WTO's subsidy system to realize a global regulation for subsidies, namely expanding the stringent State aid control of the EU to other countries via bilateral or even multilateral means.[592] Some authors predicted that the EU would continue with the steps to gain

[589] Council Decision of 16 September 2010 on the signing, on behalf of the European Union, and provisional application of the Free Trade Agreement between the European Union and its Member States, of the one part, and the Republic of Korea, of the other part [2011] OJ L127/1.
[590] European Commission, EU-South Korea Trade Agreement 10 Key Benefits for the European Union, June 2011 <http://ec.europa.eu/trade/policy/countries-and-regions/countries/south-korea> assessed 21 November 2015.
[591] James Harrison, 'The European Union and South Korea the Legal Framework for Strengthening Trade, Economic and Political Relations' (2013) 87-102.
[592] Ibid.

more market access in Asian countries, such as China, through bilateral FTAs.[593] Therefore, the FTA also provides the possibility for China to apply the EU State aid law, as a testing standard, to Chinese tax incentives.

This chapter first carries out the testing of selected Chinese tax incentives against the subsidy rules in the WTO (the ASCM) through the testing steps outlined in Chapter 3. Subsequently, it conducts the comparative testing against EU State aid law. In order to make the comparison clear, each part of the testing directly follows the WTO's testing analysis. Afterwards, the chapter reviews the testing with both external and internal benchmarks that are established in Chapter 3 and 4, thereby presenting testing results.

5.2 Testing Chinese tax incentives against the ASCM and EU State aid law

Chapter 3 has developed concrete testing steps under the ASCM and EU State aid law for the identification of tax incentives as subsidies or State aid. The testing in this section follows the testing steps outlined in Chapter 3. Additionally, Chapter 4 described specific tax incentives in China, which are the subject of the testing in this chapter.

It has to be admitted at the beginning that there are similarities of the rules that identify a measure as a subsidy or State aid in the two systems. These form the basis of the comparison, but the research does not carry out a duplicate analysis due to identical testing steps or methods in the two systems. In contrast, the research focuses more on the differences in the testing steps and analysis, because even if some testing steps are similar, there are still differences in details, especially in the analysis. Hence, the testing analysis demonstrates both the similarities and differences in the identification of subsidy or State aid.

5.2.1 The WTO: financial contribution made by a government or any public body & the EU: aid granted by a Member State or through state resources

5.2.1.1 The WTO: financial contribution

A subsidy consists of a financial contribution by a government or any public body within the territory of a Member. The first testing step is to examine the existence of a financial contribution. The ASCM has listed major forms of financial contributions, one of which is closely linked with tax incentives: government revenue that is otherwise due is foregone or not collected. Chapter 3

[593] Ibid.

established that a tax incentive is a form of financial contribution.[594] Tax incentives mean that the government gives up a certain amount of tax revenue to achieve some policy goals by granting a tax exemption, refund, or credit, etc. If the granting of tax incentives leads to a decrease of government revenue compared to the normal situation, a financial contribution would be deemed to exist in the form of government revenue that is otherwise due is foregone or not collected.

With respect to Chinese tax incentives, no matter what form they take, they should be collected due to or the compulsory feature of taxation, but the non-collection of taxes causes a loss of revenue for the government. For instance, for corporate tax, the calculation of the amount of taxable income is stipulated in Article 22 of the EIT Law. "*The amount of tax payable by an enterprise shall be equal to the enterprise's taxable income times its applicable tax rate, less the amount of its allowable reductions, exemptions, and tax credits pursuant to the provisions of this law on tax incentives*". Therefore, the amount of the tax incentive is deducted from the total amount of the revenue, which enables the enterprises to pay less tax. Therefore, it constitutes a "financial contribution" according to the ASCM.

5.2.1.2 The EU: aid granted by a Member State or through state resources

Similarly, State aid in the form of tax measures would trigger a loss of revenue, which is equivalent to a consumption of state resources. Tax measures fulfill the requirement of being granted through state resources. Thus, the effect is the same as with a "financial contribution" in the form of government revenue that is otherwise due which is foregone or not collected under the ASCM.

5.2.2 The WTO: benefit conferred & the EU: economic advantage

5.2.2.1 The WTO: benefit conferred

To determine the existence of a benefit, it is necessary to examine whether the financial contribution placed the recipient in a more advantageous position than it would have been otherwise.[595] It is an effect-based test. According to the case law, a comparison must be conducted between the benefits received from the government and the benefits that would have been obtained under normal market conditions.

[594] See Section 3.3.1.1 financial contributions in Chapter 3.
[595] See 2.4.1.2 Benefit conferred in Chapter 2. WT/DS70, Canada-Aircraft, 14 April 1999, Panel Report, at para.9.112-9.113.

Tax incentives enable taxpayers to pay less taxes compared to the situation without them. They offer taxpayers the opportunity to deviate from the normal benchmark, taxes that should be paid, to gain a competitive advantage. These benefits are offered intentionally by the government to achieve particular goals. However, it is difficult to measure whether the incentives actually benefit the taxpayers or not, and therefore the comparison helps to establish whether the tax incentive puts the recipient in a more favorable position than other non-recipients. A lower tax liability is indeed beneficial to taxpayers compared to other taxpayers who pay the full tax amount. Thus, tax incentives are beneficial for their recipients.

In the situation in China, a distinction is made between benefits granted through direct and indirect tax incentives. Direct tax incentives provide advantages to the receiving enterprises, since the recipients gain more than they would have gained under normal market conditions. The effect is identical to granting subsidies. For example, in the EIT Law, qualified SLEs shall enjoy a reduced tax rate of 20% and qualified high-tech enterprises can also enjoy a reduced tax rate of 15%, as opposed to the standard tax rate of 25%. A reduced tax rate actually means that the enterprise pays less tax, thus resulting in a lower financial burden and more possibilities of an advantageous competitive position compared to other enterprises that do not benefit from the reduced tax rate.

With regard to indirect tax measures, the effects differ as there are different methods of providing these incentives. As analyzed in Chapter 4, the most frequently used form of VAT incentives, exemptions, is not always beneficial to the recipients if it is granted in the intermediate stage of the VAT chain. If exemptions are granted prior to final consumption, they can benefit the seller, as VAT is not levied at the final stage. However, if they are granted in the intermediate stage, they will actually break the VAT chain, thereby leading to increased consumer prices and double taxation due to the VAT levied prior to the exempt stage. Therefore, in this situation, the granting of VAT exemptions will not benefit the recipients and is not sufficient to constitute a subsidy. The Chinese VAT exemption for energy saving enterprises provides a good example.[596] The exemption is provided when transferring VAT taxable goods to energy consumption enterprises, if the products are sold to consumers. This exemption benefits the seller or the producer, as they do not have to pay the VAT that is otherwise due. However, once the sale is to

[596] See Section 4.7.2.3 Matrix of specific VAT incentives in Chapter 4.

downstream enterprises instead of the final consumers, the downstream enterprises have to increase the price to cover the cost of the input VAT that cannot be deducted when received from the upstream seller because of the exemption. To test Chinese VAT exemptions, it is necessary to analyze whether or not the exemptions are granted merely prior to the final consumption stage and, if so, they will likely result in benefits for the taxpayers because they do not have to pay the output VAT that is otherwise due. However, if this is not the case, it can be determined on a case-by-case basis whether a benefit is actually conferred on the recipients.

5.2.2.2 The EU: economic advantage

The method of identifying whether there is an advantage is identical in the State aid regime as it also takes an effect-based approach. To be specific, testing whether there is an advantage is subject to more concrete standards in order to compare the financial situation of the undertaking before and after it receives the tax incentive. It is based on an analysis of whether or not the preferential tax treatment can make the undertaking better off, such as due to an improvement of the financial situation or the prevention of financial loss. Hence, the analysis of Chinese tax incentives against State aid rules is similar to the examination under the ASCM. Direct tax incentives grant advantages to the recipient, but the effect of VAT incentives is clear only after a case-by-case analysis.

5.2.3 The WTO: specificity & the EU: selectivity

5.2.3.1 The WTO: prohibited subsidies & the EU: State aid

An essential testing step in examining subsidies is the identification of specificity, which distinguishes measures that favor specific enterprises from general measures. However, considering the harmful effects of export subsidies and import-substituting subsidies, once they can be categorized as prohibited subsidies, they are automatically deemed to be specific. They do not have to be analyzed for specificity.

(1) The WTO: prohibited subsidies

a. Export subsidies

I. Direct tax incentives

The illustrative list of export subsidies of the ASCM lists direct tax incentives that constitute export subsidies: (e) The full or partial exemption, remission, or deferral specifically related to

exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.[597]

Since the Reform and Opening Policy in 1978, China has launched a number of tax incentives toward FIEs to attract FDI, including some export-oriented tax incentives.[598] Applying the ASCM rules to those export-oriented tax incentives, they can easily be identified as export subsidies. The reason for this is that qualified export-oriented enterprises may enjoy a reduced tax rate, the effect of which is similar to "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes". What is more, they are contingent upon export performance.

However, these export-oriented tax incentives expired after the launch of the new EIT Law. Actually, after its further integration into the world economy, China abolished most of the tax incentives favoring foreign enterprises after the implementation of the new EIT Law, including those for export-oriented enterprises. Only some tax incentives were reserved for a transitional period of five years to offer foreign investors the time to adapt to the new EIT Law regime. When the transitional period was over in 2013, those tax incentives were also terminated.[599]

Currently, there are few tax incentives for exports. As described in Chapter 4, the present corporate tax incentives are not specifically export-oriented but rather they focus more on state-supported industries or regions. It seems that China has also learned lessons from the investigations in the WTO and has cancelled the official export-oriented tax incentives.

[597] See the illustrative list of export subsidies of the ASCM.

[598] For instance Article 75 (7) of the Rules for Implementation of the FEITL, it was stipulated that "export-oriented enterprises invested in and operated by foreign business for which in any year the output value of all export products amounts to 70% or more of the output value of the products of the enterprise for that year may pay enterprise income tax rate specified in the tax law reduced by one half after the period of enterprise income tax exemptions or reductions have expired in accordance with the provisions of the tax law".

[599] Article 57 of the EIT law: "an enterprise set up upon approval prior to the promulgation of this Law that enjoys the preferential policy of a low tax rate in accordance with the laws and administrative regulations governing taxation of the time may, pursuant to the relevant regulations of the State Council, gradually go over to the tax rate prescribed by this Law within five years after this Law goes into effect; an enterprise that enjoys the preferential policy in the form of regular tax exemption or reduction may, pursuant to the relevant regulations of the State Council, continue enjoying such policy after this Law goes into effect, until the period for such policy expires; however, if it has not enjoyed such policy because it fails to make any profits, the period for such policy shall be calculated from the year this Law goes into effect".

II. VAT incentives

The rebate of indirect taxes on exports is not an export subsidy, as it can be justified by the destination principle. As introduced in Chapter 3, under the ASCM, only the excessive exemption, remission, or deferral of prior-stage cumulative indirect taxes in respect of the production and distribution of exported products are considered to be export subsidies. In China's VAT export refund practice, generally, there is no full VAT refund, not to mention the excess of tax refund. Therefore, the general VAT export refund regime cannot be considered to constitute an export subsidy.

In China's situation, although China adopted zero rates for export refunds, in practice it was difficult to realize a complete VAT refund for exportation for the following reasons. On the one hand, it causes the central government a heavy fiscal burden to rebate all the VAT on exportation. Exportation increased rapidly after the zero rate regime in 1994. After China's accession to the WTO in 2001, the export refund claims surged so tremendously that the central government felt it as a great burden on the budget. Therefore, it had to change the refund rates.[600] On the other hand, the export refund was utilized by the government as an instrument of trade policy.[601] The frequent adjustments of the refund tax rates indicated that the government adopted the regime as tax incentives or subsidies to encourage or discourage the export of different industries. However, as long as the export refund is used by the government as an instrument of trade policy, there is a great possibility that excessive export refunds will be granted which will fall within the scope of export subsidies.

b. Import-substituting subsidies

Among the present tax incentives, there is no explicit incentive for the use or purchase of domestic goods over imported ones. It seems that China is more and more familiar with the WTO standards and knows how to avoid granting tax incentives that are inconsistent with the WTO rules, particularly with regard to incentives provided for in official legislation. This is not only a requirement for China to fulfill its obligations as a WTO Member, but it is also a demonstration of China's changing attitude towards FIEs, from being eager to increase FDI by providing

[600] J. Whalley and L. Wang, Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus, NBER Working Paper No. 13581, 2007.
[601] Wei Cui and Alan Wu, the Chinese VAT, in Thomas Ecker, M. Lang and I. Lejeune, *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems Around the World* (Wolters Kluwer Law & Business, Kluwer Law International 2012) 159-189.

numerous FDI-favored tax incentives to having confidence in being able to attract FDI without granting preferential tax treatment.

Before the new EIT Law, there were also tax incentives encouraging FIEs to use or purchase domestic goods instead of imported goods, which may constitute import-substituting subsidies. In the China-Taxes case in 2007, Mexico claimed that Chinese tax incentives for FIEs were import-substituting subsidies since they appeared to provide tax refunds on the condition that those FIEs purchased domestic rather than imported goods.[602] For instance, they found that FIEs in China that purchased domestic equipment were qualified to enjoy tax credits.[603] It is obvious to see that this kind of tax incentive is offered to FIEs that purchase domestic equipment and if FIEs purchase imported or foreign equipment, they cannot enjoy such a tax credit. Thus, it favors the use of domestic over imported goods, which are likely to be identified as import-substituting subsidies under the ASCM. However, with the effectiveness of the new EIT Law, all these import-substituting subsidies which were contested by Mexico have expired or have been terminated.

(2) The EU: material selectivity

One distinction between a subsidy in the ASCM and State aid is that the State aid system does not distinguish export or import-substituting measures from other measures. This means that prohibited subsidies under the ASCM still have to go through the selectivity test under the State aid regime. After the testing under the ASCM, it seems that export subsidies are quite few at present. For the general VAT refund in China, the analysis is similar to the one under the ASCM, which is not selective either. Thus, it is not likely to be considered as State aid.

5.2.3.2 The WTO: actionable subsidies & the EU: State aid

Specificity is an essential characteristic of actionable subsidies. If a tax incentive is limited to certain enterprises or groups of enterprises, or industries, but it is not available to all enterprises or

[602] WT/DS359/1, China-Taxes, Mexico's Request for Consultations in the WTO, 26 February 2007. Mexico listed evidence of Chinese law providing tax incentives, including tax refunds, tax credits, tax exemptions, and tax reductions, to FIEs for the investment in Chinese domestic or homemade equipment. On 7 February 2008, China and Mexico informed the DSB that they had reached an agreement in relation to this dispute, in the form of a memorandum of understanding.

[603] Article 1, Caishuizi [2000] No.49, Circular of the MoF and the SAT Concerning the Issue of Tax Credit for Business Income Tax for Homemade Equipment Purchased by Enterprises with Foreign Investment and Foreign Enterprises, 14 January 2000 (expired). There were similar provisions in other legal documents, which were listed by Mexico as evidence in the China-Taxes case. See WT/DS359/1, China-Taxes, Mexico's Request for Consultations in the WTO, 26 February 2007.

industries, it shall be considered specific. In addition, regional specificity focuses on subsidies in a designated geographical region. There is a classification between *de jure* and *de facto* specificity to include all forms of specific subsidies and not only the subsidies set out explicitly in the law as being specific. Subsidies that are specific due to the factual situation have to be examined for adverse effects.

(1) The WTO: Enterprise or industry specificity

a. *De jure* specificity

As introduced in Chapter 4, both direct and indirect tax incentives are granted to specific enterprises or industries that are explicitly stipulated in the legislation, including high-tech enterprises, software industry and integrated circuit (IC) industry, energy-saving services enterprises, animation industry, and small and low profit enterprises (SLEs).

Subject	Highlights of the incentives	Eligibility
High-tech enterprises	**EIT incentives:** 15% CIT rate; exemption of income from the transfer of technology; additional deduction for R&D expenses; accelerated depreciation; special deductions for eligible investors in high-tech enterprises, etc.	(1) products (services) are within the scope prescribed in the Hi-tech Sectors Eligible for Key Support from the state; (2) the proportion of R&D expenditures to sales revenue is not lower than a prescribed ratio; (3) the proportion of the revenue derived from high-tech products (services) to the total revenue of the enterprise is not lower than a prescribed ratio; (4) the proportion of the number of R&D personnel to the number of all employees is not lower than a prescribed ratio; (5) other conditions
Software industry and integrated circuit (IC) industry	**EIT incentives:** (1) Tax exemptions for the first few years starting from the first profit-making year; (2) 15% EIT rate **VAT incentives:** (1) Regular taxpayer who sells the self-developed software products, after being taxed 17% VAT, the actual VAT burden that surpasses 3% will be granted the incentive of immediate	**EIT incentives:** (1) a. IC lines the width of which is less than 0.8 microns (inclusive), have been identified before 31st December 2017; b. IC lines the width of which is less than 0.25 microns or the investment amount is over 8 billion RMB; (2) Key software enterprises and IC design enterprises included in the state planning **VAT incentives:**

	taxation and immediate refund (14% refund); (2) Import VAT exemption for imported self-used production materials and consumables	(1) Regular taxpayers who sell self-developed software products (2) Imported software products after the localization transformation
Energy-saving services enterprises	**EIT incentives:** Tax exemptions for the first three years starting from the first profit-making year, and from the fourth to the sixth year, CIT shall be cut half based on the 25% CIT rate **VAT incentives:** Exemption of VAT	**EIT incentives:** Independent legal entity with a registered capital of no less than one million yuan, and can provide diagnostic energy situation, energy project design, financing, renovation, operational management, personal training and other services **VAT incentives:** Qualified energy-saving services enterprises implement energy performance contracting projects, and transfer the VAT taxable goods to energy consumption enterprises
Animation enterprises	**VAT incentives:** 1. Immediate taxation and immediate refund of VAT; 2. Exemption of import VAT	**VAT incentives:** 1. Regular taxpayers who sell self-developed software products, after being taxed at 17% VAT, are refunded the actual VAT burden which surpasses 3% (14% refund); 2. Products that are necessary to be imported
Small and low profit enterprises (SLEs)	**EIT incentives:** 3. 20% EIT rate 4. The taxable income was calculated as 50% of the annual income, and 20% EIT rate **VAT incentives:** Exemption of VAT	**EIT incentives:** 1. (1) Industrial enterprises: the taxable income for the year shall not exceed RMB 300,000; total employees shall not exceed 100, and total assets shall not exceed RMB 30 million; (2) Other enterprises: the taxable income for the year shall not exceed RMB 300,000, total employees shall not exceed 80, and total assets shall not exceed RMB10 million. 2. Until 31st December 2017 The annual income is lower than 300,000 RMB **VAT incentives:**

		1. The monthly sales of a SLE is below 20,000 RMB 2. Before 31st December 2017, the monthly sales of the SLE is between 20,000 to 30,000 RMB

According to the specificity criteria in the ASCM, these tax preferences, both direct and indirect, are only granted to certain enterprises or industries but not to other enterprises or industries, and therefore they are specific. Furthermore, for software and IC industry, SLEs, and energy-saving service enterprises, both direct tax incentives and indirect tax incentives are granted. This has exhibited the state's preferential attitude towards these industries or enterprises. The combination of tax incentives strengthens the power to achieve the objective. In order to promote the development of the software and IC industry, the government launched a series of beneficial measures to achieve the goal, and tax incentives are among those measures. This is the same for SLEs and energy-saving services enterprises.

The first Chinese tax case in the WTO was a value-added tax case brought to the DSB by the US in 2004.[604] In China-VAT on Integrated Circuits, the US claimed that, although China granted 17% VAT on ICs, enterprises were entitled to immediate taxation and an immediate refund of the actual VAT that had surpassed 6%, thereby resulting in a lower tax rate on IC products.[605] Although the US did not start subsidy investigations in this case, the ASCM can also be applied here since the VAT incentives would probably constitute actionable subsidies.[606] In this case, the immediate taxation and immediate refund is a particular form of "collect and return" that aims at reducing the tax burden of IC enterprises. Therefore, it is specific to an enterprise or industry. Currently, there are still similar VAT incentives granted for IC enterprises. Similarly, they are likely to constitute actionable subsidies with industry specificity.

[604] WT/DS309/1, China-Value-Added Tax on Integrated Circuits, 23 March 2004, Panel Report.
[605] In addition, China also permitted immediate taxation and immediate refund of VAT that had surpassed 6% to domestically designed ICs that were manufactured outside China for technological limitations. The US considered it as favoring imports from one Member than another, thus discriminating against other Members and violating the Most-Favored-Nation Treatment under Article 1 of GATT 1994. The case was solved by a mutually agreed solution that China had to abolish the VAT incentive for IC enterprises in 2005.
[606] Ying Liu, 'The Relationship between the ASCM and China's VAT Refund, Discussion from the Two Cases towards China in the WTO' (2008) 6 Legal Science (in Chinese).

I. Exemption of SLE's specificity

Article 2.1 (b) of the ASCM grants an exemption for specificity and this exemption is likely to be applicable to SLEs.

"*where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification.*"

As explained in the ASCM, objective criteria or conditions mean criteria or conditions which are neutral, which do not favor certain enterprises over others, and which are economic in nature and horizontal in application, such as the number of employees or the size of an enterprise.[607] The size of SLEs is determined by the taxable income of the enterprises, the number of employees, and the total assets. It satisfies the objective criteria or conditions for the exemption. Moreover, the criteria are stipulated and confirmed in legal documents. Not all enterprises can be qualified as SLEs. Hence, if the criteria are strictly adhered to and the eligibility is automatic, these tax incentives cannot be deemed to be specific pursuant to Article 2.1 (b) of the ASCM.

To conclude, the tax incentives for high-tech enterprises, for the software industry and IC industry, for energy-saving enterprises, and for animation enterprises are specific within the meaning of the ASCM. Nevertheless, tax incentives for SLEs should not be regarded as specific under the justification of Article 2.1 (b) of the ASCM.

b. *De facto* specificity

There are tax incentives that are not limited to specific enterprises or industries, but they can be considered de *facto* specific if they actually favor certain enterprises or industries. The ASCM lists situations that can be regarded as specific in fact, including the use of a subsidy program by a limited number of certain enterprises; the predominant use by certain enterprises; the granting of disproportionately large amounts of subsidy to certain enterprises; and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy.[608]

[607] See footnote 2 of the ASCM.
[608] Article 2.1 (c) of the ASCM.

With respect to direct tax incentives, in the EIT law, there are tax exemptions or reductions granted to state-supported projects: investments in projects for farming, forestry, animal husbandry, and fisheries; investments in the operation of infrastructure projects that have the major support of the state; qualified projects or environmental protection on energy and water conservation; and qualified technology transfer etc.[609]

I. Use of a subsidy program by a limited number of certain enterprises

Although tax incentives are granted in the form of investments in different state-supported projects, they can benefit certain enterprises in practice. Nowadays, the specialization of enterprises is evolving so rapidly that most enterprises are specialized in individual industries or the production of certain goods. For instance, enterprises whose main business is technology transfer will probably become the major beneficiary of the incentives for income derived from these investments.[610] Similarly, enterprises focusing on projects of environmental protection or energy and water conservation will benefit more from these incentives.[611]

II. Predominant use by certain enterprises: SOEs

Major Chinese state-owned enterprises (SOEs) will benefit more from the tax incentives for investments in infrastructure projects than other enterprises.[612] According to Article 87 of the RIEITL, major state-supported public infrastructure facility projects refer to projects listed in the Catalogue of Enterprise Income Tax Incentives for Public Infrastructure Facility Projects, such as pier and dock projects, airports, railroads, roads, urban public transportation, electricity projects, water resources utilization projects, etc.[613]

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[609] Article 27 of the ETI Law.

[610] Article 27 of the EIT Law stipulates that there are tax exemptions or reductions granted to state-supported projects: investments in an operation of infrastructure projects that have the major support of the state, qualified projects or environmental protection on energy and water conservation, and qualified technology transfer etc.

[611] According to Article 88 of the RIEITL, environmental protection, energy and water conservation projects include sewage treatment, public refuse treatment, comprehensive development and utilization of methane, technologies alternation for energy-saving and emission reduction, seawater desalination, etc. Enterprises engaged in these projects shall be exempted for the first to third years and allowed a 50% reduction in the fourth to sixth years beginning from the tax year the project derives its first production and operation income.

[612] This tax incentive is stated in Article 27 (2) of the EIT Law.

[613] In the case of income derived from those major state-supported public infrastructure facility projects, with effect from the first year to which manufacturing or business operational revenue earned from the project is attributable, a credit shall be allowed for the entire enterprise income tax on that income from the first to third years and a 50% credit from the fourth to sixth years. See Article 87 of the RIEITL.

Although it seems that the tax exemption or tax reduction is granted to any public infrastructure facility projects, the category of public infrastructures has excluded investment from private enterprises and foreign enterprises. It reflects that the state-owned economy is the leading force in the national economy.[614] With respect to tax incentives provided to the public infrastructure facility projects, most of the projects fall within the scope of the strategic and pillar industries. Private enterprises have no access to those state-supported projects or sectors as they are only dominated by SOEs.[615] Therefore, SOEs are the main beneficiaries of these tax incentives, especially those whose main business involves the state-supported projects. In addition, as analyzed by Cui (2015), empirical evidence on a firm level showed that centrally owned SOEs had lower effective tax rates than or tax rates similar to private firms in certain sections.[616] Consequently, these tax incentives are likely to be *de facto* specific to SOEs for the reason of predominant use by certain enterprises.

(2) The EU: material selectivity

In the State aid law system, as described in Chapter 4, there are concrete testing steps to identify the selectivity of tax measures. First, a general standard shall be determined; second, it has to be examined whether there is a deviation from the general standard; third, it has to be determined whether the tax measure at issue can be justified by the nature or general scheme of the system.[617] After these three testing steps, tax measures can be classified as materially selective or regionally selective.

Following the selectivity standard, an analysis of Chinese tax incentives differs from the analysis for WTO regime. Firstly, the general or normal standard to determine selectivity is that taxpayers pay full taxes. Subsequently, it has to be established that those specific tax incentives are deviations from the normal benchmark. According to the EU case law, a deviation from the normal standard means demonstrating that the measure at issue "derogates from that common

[614] Article 6, Constitution of the People's Republic of China (2004 Amendment).
[615] Lei Zheng, Benjamian L. Liebman and Curtis J. Milhaupt, 'SOEs and State Governance' in Benjamin L. Liebman and Curtis J. Milhaupt (eds), *Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism* (Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism, Oxford University Press 2015) 209.
[616] Wei Cui, 'Taxation of State Owned Enterprises: A Review of Empirical Evidence from China' in Benjamin Liebman and Curtis Milhaupt (eds), *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism* (Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism, Oxford University Press 2015) 119-120.
[617] The 2016 Notice, at para. 128.

regime inasmuch as it differentiates between economic operators who, in light of the objective assigned to the tax system of the Member State concerned, are in a comparable factual and legal situation".[618] These specific tax incentives grant possibilities for taxpayers not to pay the normal taxes compared to other taxpayers in comparative situations. They therefore can be regarded as deviations from the general standard of taxation, whether it is in the form of direct tax or indirect tax. The third step is to examine whether the derogation can be justified by the nature or general scheme of the system. As analyzed before, these tax incentives are granted for particular purposes, such as supporting the development of high-tech innovation, software industries, and SLEs, which are far from being necessary for functioning and effectiveness of the tax system. Therefore, it is difficult to establish that they are justified by the nature and general scheme of the system. In conclusion, after the three-step test, those tax incentives with enterprise or industry specificity under the WTO's subsidy regime are also selective according to EU State aid law.

(3) The WTO: regional specificity

Except for enterprise or industry specificity, regional specificity is another significant factor in identifying subsidies. If a subsidy is limited to certain enterprises located within a designated geographical region within the granting authority's jurisdiction, it can be categorized as a subsidy with regional specificity. The exact method of identification has been discussed in Chapter 3.

With respect to Chinese tax incentives, before the EIT Law, a great number of tax incentives were granted to FIEs in Special Economic Zones (SEZs), Economic and Technological Development Zones (ETDZs), coastal open economic areas (COEAs), etc.[619] These tax incentives were limited to FIEs in designated regions, and thus probably constituted regional subsidies. However, under the current tax law regime, regional tax incentives are mainly granted within autonomous regions, the western region, comprehensive experimental zones (CEZs), and Free Trade Zones (FTZs), etc.

a. Autonomous regions

According to the definition of subsidies in the ASCM, it seems that the discretionary power of the autonomous regions to grant tax incentives is likely to result in regional subsidies if they are

[618] CJEU Joined Cases C-78/08 to C-80/08 *Paint Graphos and others* [2011] ECR I-7611, at para. 49. See also CJEU C-143/99 *Adria-Wien Pipeline v Wietersdorfer & Peggauer Zementwerke* [2001] ECR I-8365, at para. 41.

[619] See the historical review of tax incentives for FDI in China in Chapter 4.

confined to certain enterprises only. To apply the regional specificity test here, firstly it is necessary to identify the granting authority. The granting authority here is the regional government. "With the jurisdiction of the granting authority", if a tax incentive is not available to all enterprises, but only limited to certain enterprises, it is specific. On the contrary, if all enterprises in the autonomous regions have access to the incentive, it cannot be considered specific. Furthermore, Article 2.2 of the ASCM also provides an exemption for subsidies that would be regionally specific. The setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to constitute a specific subsidy. Following this logic, provided that autonomous regions are allowed to set a lower income tax rate than the standard one, once this lower tax rate is applicable by all levels of governments in the whole area of the autonomous region, it will not be deemed to be specific. However, this Article only addresses one situation of tax incentives, the change of tax rates, thus leaving out other situations of tax exemptions or reductions, although they could have the same effect of reducing tax revenue. Hence, the other types of tax incentives still fall within the scope of regional specificity once they are granted to particular enterprises in autonomous regions.

To conclude, if local governments in autonomous areas grant tax reductions or exemptions to all enterprises in the region, the reductions and exemptions cannot be deemed to be actionable subsidies; however, if the governments grant tax incentives to specific enterprises, they will probably constitute actionable subsidies with regional specificity.

b. Western Development Strategy (WDS)

As explained in Chapter 3, western regions are historically less developed than the eastern and central regions, and the disparity between the regions is still increasing. Similar to the identification of regional specificity in autonomous regions, firstly it is necessary to identify the granting authority. As introduced in Chapter 3, China is a unitary country in which the sub-national governments do not have discretionary power to grant tax incentives without the central government's authorization. Although the WDS is aimed at promoting regional development, it is designed and announced at the central government level. All tax incentives are granted by the central government but only implemented by local governments.[620] Therefore, if "within the jurisdiction of the granting authority", although the tax incentives are available to all enterprises

[620] Tax incentives of the WDS are granted by the SAT, which represents the central government.

within the western regions, they are regionally specific since other regions in China do not enjoy such incentives. However, even within those autonomous regions where the local government has certain fiscal autonomy, under the framework of the WDS, tax incentives are still granted in the name of the central government.

With respect to tax incentives in designated western regions, investment in the state-encouraged industries can enjoy a reduced enterprise income tax rate of 15%. VAT is exempted for imported self-used equipment within the lump sum investment in state-encouraged industries, encouraged industries for FDI and projects of competitive industries.[621] The specificity lies in the fact that only investments in state-encouraged industries are eligible to enjoy these tax preferences and other industries are excluded. A Catalogue of Western Region Encouraged Industries has listed industries that are qualified for tax incentives engaging in a wide scope, such as manufacture, public infrastructure, financial services, IT industries, transportation, environmental protection, etc.[622] It cannot be justified by Article 2.2 of the ASCM because the lower tax rate is not applicable to all enterprises in the region but is granted to limited eligible industries. Consequently, these major tax incentives of the WDS are likely to be identified as subsidies with regional specificity under the ASCM, even though it is a significant national strategy of China.

c. Comprehensive Experimental Zones (CEZs)

Direct tax incentives in the CEZs are similar to those granted in the WDS regions, i.e. 15% enterprise income tax rate for investment in the CEZs until 31 December 2020. When applying the standard of the ASCM to test the specificity of the measures, they are likely to be identified as regionally specific for the reasons similar to those for the WDS. The granting authority of these tax incentives is also the central government[623] and the incentives are only available to enterprises in the CEZs and therefore they are regionally specific. Moreover, the fact that only state-encouraged industries in the regions are qualified to enjoy the preferential treatment also makes the incentives regionally specific. The legal document of the CEZs has listed an inventory of

[621] Caishui [2011] No.58, Notice of Tax Policy Issues Regarding Further Implementation of the Western Development Strategy, by the MoF, the GAC, and the SAT, 27 July 2011.
[622] Fagaiwei [2014] No.15, The Catalog of Western Region Encouraged Industries, by National Development and Reform Commission, 20 August 2014.
[623] Similar to tax incentives of the WDS, tax incentives for the CEZs are also granted by the SAT.

industries as state-encouraged industries for which investments can enjoy such a lower tax rate.[624] Hence, the testing here is identical to the testing carried out for the WDS incentives.

All the three CEZs, Hengqin, Pingtan, and Qianhai, have special geographical advantages compared to Macao, Taiwan, and Hong Kong, and thus the establishment of CEZs in these regions aims at strengthening the cooperation between mainland China and the three regions. Except for economic and financial reasons to promote the prosperity of the regions, political considerations are even more important. Although Hong Kong and Macao have been once again part of China for over 15 years, there are still challenges to ensure their political stability and continuous economic growth.[625] Therefore, tax incentives in the CEZs are expected to contribute to the political stability of these regions.

d. Pilot Free Trade Zones (FTZs)

Under the framework of the ASCM, at present, the tax incentives provided in the FTZs are still likely to constitute actionable subsidies with regional specificity because only enterprises registered in the FTZs can enjoy them. All the measures in the FTZs are implemented by the State Council, the central government. However, the local governments also have the authority to design and introduce detailed rules to guarantee the implementation of those incentives. The State Council even granted a larger margin of discretionary power to these local governments for policy innovations. In this situation, both the central and the local government have participated in the granting of those tax incentives in the FTZs, and therefore the tax incentives still should be regarded as being granted by the central government, according to the interpretation the regional specificity in the ASCM. Hence, the benchmark for the determination of regional specificity is the whole country, the State Council's range of power. If only enterprises in the FTZs can enjoy those tax preferences, although they are available for all enterprises in the FTZs, they are regionally specific.

[624] According to the Catalog of Enterprise Income Tax Incentives for CEZs, state-encouraged industries include modern logistics, information services, technology services, cultural and creative industries, etc. See Caishui [2014] No.26, Notice on Enterprise Income Tax Incentives and Catalogue for Guangdong Hengqin New District, Pingtan Comprehensive Experimental Zones, and Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, by the MoF and the SAT, 25 March 2014.

[625] Wilson Wai Ho Wong and others, 'Contemporary Hong Kong Government and Politics' (2012) 325-348; Fengxuan Xue, 'Macau through 500 years emergence and development of an untypical chinese city' (2013)

Nevertheless, after the trial operation of the FTZs, enterprises considered that they did not benefit much from those incentives.[626] Some investors were even disappointed, especially foreign banks, because they did not experience many changes of liberalization in the financial market. From their observations, it took longer than expected to materialize the benefits of the policies.[627] This phenomenon confirms that the FTZ is not the next SEZ by granting tax incentives to draw FDI, but a testing ground for decentralization and economic reforms.[628]

(4) The EU: regional selectivity

a. Autonomous regions

The State aid regime takes a strict approach towards regional selectivity. If a tax measure does not apply to the whole territory of the country, it may be deemed to be selective for certain regions. However, the 2016 Notice has confirmed that tax measures provided in regions that have fiscal autonomy may not constitute State aid. To apply this justification, it is rather complicated to establish the existence of fiscal autonomy. As analyzed in Chapter 3, the identification of fiscal autonomy requires institutional autonomy, procedural autonomy, and financial autonomy.[629]

In China's situation, it is necessary to test the regional selectivity of autonomous regions. With respect to institutional autonomy, the 2016 Notice confirmed that an autonomous region must have its own separate political and administrative status and self-governing institutions and its own fiscal competence, especially with the power to adapt national fiscal provisions to regional particularities.[630] The Chinese autonomous regions have their own self-government organs, which have the competence to exercise their fiscal powers.[631] Thus, the requirement of institutional autonomy can be fulfilled. In addition, procedural autonomy means that the region can adapt a tax

[626] Shanghai's Free Trade Zone, Li who will not be obeyed, The Shanghai Free Trade Zone's Frustrating first year, The *Economist* (11 October 2014) <http://www.economist.com/news/china/21623776-shanghai-free-trade-zones-frustrating-first-year-li-who-will-not-be-obeyed> accessed 5 March 2015; Shanghai Free-Trade Zone Struggles to Live up to its Hype, *Financial Times* (2 September 2014) <http://www.ft.com/intl/cms/s/0/b6985580-324f-11e4-b929-00144feabdc0.html#axzz3TWUT7H9a> accessed 5 March 2015.

[627] Ibid.

[628] Wan and others, 'Policy and Politics behind Shanghai's Free Trade Zone Program' 5-6.

[629] See Section 4.6.3.1 Autonomous regions in Chapter 4.

[630] CJEU Case C-88/03 *Portugal v. Commission* [2006] ECR I-7115, at para. 70. See also Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU [2014] p.39.

[631] It is confirmed by Article 95 of Constitution of the People's Republic of China (2004 Amendment).

measure without the central government's direct intervention in its content.[632] Actually, the EIT Law has granted discretionary power to autonomous regions so that they may decide to reduce or exempt enterprise income tax within the regions.[633] This discretionary power also connects to economic and financial autonomy. The interpretation of economic and financial autonomy is that the autonomous region bears responsibility for the political and financial consequences of tax reliefs, i.e. it has control of its own revenue and expenditure. In Chinese autonomous regions, tax exemptions or reductions have financial support from the regions since all revenues accruing to the regions are managed and used by the regions.[634]

Therefore, under State aid law, it seems that Chinese autonomous regions could find justifications. The normal benchmark to decide selectivity should be the autonomous regions themselves instead of the country as a whole. As a result, even if there are tax reductions or exemptions in those autonomous regions, it is not a deviation from the general standard because the reference is the regions themselves. In conclusion, it can be established that tax incentives granted by the autonomous regions are not necessarily State aid.

b. WDS, CEZs, and FTZs

The implementation of these regional strategies has different purposes, but once they are not applied to the whole territory of the country, under the State aid law regime, they are regionally selective. Tax incentives granted in the regions of the WDS, the CEZs, and FTZs are only designated in these regions, but they are not available throughout the country. Thus, they are likely to be considered to be regionally selective in this testing step if State aid law applies.

5.2.4 The WTO: adverse effects & the EU: affect competition and trade between Member States

5.2.4.1 The WTO: adverse effects of actionable subsidies

Actionable subsidies are effect based. Except for the identification of financial contributions, benefits, and specificity, if the measure causes adverse effects to another Member's interests this

[632] CJEU Joined Cases C-428/06 to C434/06 *UGT-Rioja and Others* [2008] ECR I-6747, at para. 96 to 100. See also Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU [2014] p.39.
[633] The case law has also held that the mere fact that the tax exemptions or reductions are subject to judicial review does not in itself mean that the region lacks procedural autonomy, since it is a feature of the rule of law. CJEU Joined Cases C-428/06 to C434/06 *UGT-Rioja and Others* [2008] ECR I-6747, at para. 80 to 83. See also Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU [2014] p.40.
[634] Article 117 of the Constitution of the People's Republic of China (2004).

establishes the existence of actionable subsidies. However, it is still complicated to prove the existence of those effects, although the ASCM has listed ways and some factors to be used for evaluation.[635]

Normally, the other Member contesting the measure has the burden of proof to establish that it has suffered injuries or adverse effects, and the causal link between the subsidy measure and injuries. With respect to Chinese tax incentives, without real and concrete statistics, it is difficult to make a judgment on their effects on the other Members. Nevertheless, some effects can be predicted. As analyzed before, those tax incentives with industry or enterprise specificity or regional specificity are likely to enjoy a preferential status in the market as they pay less tax than other competitors, under the same circumstances. Consequently, they bear less costs of production, and thus have more possibilities to reduce the price of the products. When they export, their products are likely to have a more advantageous position on the market than the domestic products of other Members.[636] In fact, once those tax incentives cause serious distortions to the competition in the market. according to the rules of the ASCM, they will constitute actionable subsidies. If the granting of those tax incentives distorts the level playing field of international trade, they are not compatible with the object and purpose of the subsidy control system in the WTO, and thereby they can face investigations or countervailing measures by other Members.

5.2.4.2 The EU: affect competition and trade between Member States

State aid is also effect-based in such a way that it not only regulates actual distortions of competition but also potential distortions. This is a main reason that it has a notification procedure and pre-investigation process to evaluate the effects of aid measures. Once the tax measure has strengthened the financial position or opportunities of the recipient, it can be regarded as impairing competition with respect to other competitors. Moreover, the measure should also affect trade between Member States. However, the system includes a category of *de minimis aid*, which has little effect on competition and trade and therefore it is disregarded from a State aid perspective.

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[635] Adverse effects: injury to the domestic industry of another Member; nullification or impairment of benefits accruing directly or indirectly to other Members under the GATT 1994, in particular the benefits of concessions bound under Article II of the GATT 1994; and serious prejudice to the interests of another Member. When evaluating the effects, some factors can help: volume of subsidized imports, their effects on prices of the domestic like products, and the impact of the imports on domestic producers. See Article 5 of the ASCM.

[636] See the economic analysis of tax incentives as subsidies in Chapter 2.

All the Chinese tax incentives analyzed before, regardless their forms, can strengthen the recipient's position in the market to different degrees. The prediction on their effects is similar to the analysis conducted in the "adverse effects" analysis of the ASCM. Nevertheless, the application of the category of *de minimis aid* here deserves more discussion. The problem is how to evaluate the effect of tax incentives that can be determined as having a minimal effect on competition and trade, especially in the area of taxation. It is difficult to find a benchmark to decide the threshold of *de minimis aid* because the granting of such tax incentives means that there is a reduction in the tax revenue collected and qualified taxpayers are all eligible to enjoy those incentives. Hence, it is difficult to decide how much tax revenue is to be lost. The *de minimis aid* standard therefore is not easy to determine. However, the design of *de mininis aid* itself provides another perspective to examine the effects of aid measures, which contributes to the efficiency and costs of the administration.

5.2.5 The WTO: Non-actionable subsidies & The EU: compatible State aid

5.2.5.1 The WTO: Non-actionable subsidies

Despite the fact that non-actionable subsidies have already lapsed due to the slow progress of negotiations, testing the incentives against the conditions of this category can shed light on the existing conditions and provide food for thought. According to the original category, non-actionable subsidies include assistance for R&D activities, assistance to disadvantaged regions, and assistance for adapting infrastructure to new environmental requirements. Therefore, some tax incentives that are otherwise deemed as actionable subsidies may find justifications under this category.

(1) Assistance for R&D activities

To be qualified for this type of non-actionable subsidy, strict conditions shall apply.[637] However, certain Chinese tax incentives can be perceived as assistance for R&D activities. For instance, among tax incentives for high-tech enterprises, there are additional deductions for R&D expenses. Although the assistance for R&D is confined to the research innovation process, the rationale deserves more attention. In fact, the overall incentives for high-tech enterprises aim at encouraging innovation of technology, which shares an identical objective with R&D activities.

[637] See Section 3.3.2.3 Non-actionable subsidies in Chapter 3.

(2) Assistance to disadvantaged regions

As analyzed earlier, the main purpose of tax incentives for autonomous regions and the WDS is to promote development of the relatively less-developed regions, thus decreasing regional disparity within China. The WDS addresses autonomous regions and other disadvantaged regions within a designated geographic area. Additionally, diverse economic indexes have shown that these regions are less developed compared to eastern and central China.[638] Hence, the strict conditions for the determination of assistance to disadvantaged regions might be satisfied when conducting the testing.

(3) Assistance for adapting infrastructure to new environmental requirements

The purpose of this type of non-actionable subsidies is to encourage environmental protection. Activities carried out by energy-saving service enterprises share the same rationale with this type of subsidy. This tax incentive attempts to assist energy-saving service enterprises to expand their business, i.e. helping more enterprises to adapt their infrastructures or strategies to save energy.

Nevertheless, compared to the provisions addressing prohibited subsidies and actionable subsidies, the rules for non-actionable subsidies are not very detailed, and therefore the testing is still on a case-by-case basis. With respect to the legal framework for subsidy regulation, the existence of this category provides further reasons for Members of the WTO to offer tax incentives with a proper object and purpose. Despite the fact that they have to be proportional to achieve the aims, the design of this category seems sounder than the current system that only contains prohibited and actionable subsidies.

5.2.5.2 The EU: Compatible State aid

A major characteristic of State aid that is different from subsidies in the WTO is that there is an exemption of certain measures from the State aid rules, i.e. compatible State aid. Compatible State aid includes mandatory exemptions, discretionary exemptions, and the General Block Exemption Regulation (GBER). Mandatory and discretionary exemptions have to go through an ex-ante assessment by the European Commission, but measures that fall within the scope of the GBER are do not have to go through the notification procedure, and are thereby are compatible with the State aid law.

[638] See Section 4.6.3 regional tax incentives in Chapter 4.

(1) Discretionary exemptions: regional aid

A discretionary exemption that is applicable in China can be found in the provision of "sectoral aid to facilitate the development of certain economic activities and regional aid to certain economic areas".[639]

This provision provides a legal basis for both sectoral aid and regional aid in terms of economic activities that do not adversely affect trading conditions to an extent contrary to the common interest. The rationale for permitting regional aid is that certain disadvantaged regions suffer serious economic difficulties that may require aid to stimulate their economic development.[640]According to the explanation of the GBER, regional aid can only be used to concentrate on the most disadvantaged regions of the EU, and therefore the permissible aid ceilings should reflect the relative seriousness of the problems affecting the development of the regions concerned. Moreover, regional aid should be effective in promoting the economic development of disadvantaged areas only if it is awarded to induce additional investment or economic activity in those areas.[641]

However, it is still complex to apply the provisions. It seems that only disadvantaged sectors or regions are eligible for this discretionary exemption. In order to qualify, thr tax incentives have to undergo a strict ex-ante assessment.[642] In the context of China, regional aid under the WDS is likely to be exempted under the assessment. It has to be acknowledged that, without specific data, it is difficult to predict the precise effects of those tax incentives, but the testing itself may still shed light on the compatibility of the regional measures.

The objective of the WDS is to decrease the regional disparity between the less developed regions and the other parts of China. The rationale for launching the WDS was introduced in previous sections, and it is similar to the rationale for compatible regional aid. Subsequently, the tax incentives have to follow the principle of proportionality, which means that they should be effective and proportional to achieve the objective. The WDS provides that investments in the

[639] Article 107 (3) c of the TFEU.
[640] Hancher, Ottervanger and Slot, *EU State Aids* 790-791.
[641] European Commission Guidelines on regional State aid for 2014-2020 [2013] OJ C209/1, at para. 6 and 7. Each Member State shall provide the Commission a regional aid map and stick to the area in the map. See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:209:0001:0045:EN:PDF.
[642] The ex-ante assessment is based on the principle of proportionality, which includes consecutive questions. See Section 3.4.2.2.3 the Commission's assessment in Chapter 3.

state-encouraged industries can enjoy a reduced EIT rate of 15% as opposed to the standard tax rate of 25%. This preferential tax treatment is not new for the western regions since it is an extension of the former strategy. Key economic indicators such as GDP growth rate, fiscal revenue growth rate, and urban and rural income have already shown that, after the implementation of the WDS, the economy has grown tremendously.[643] Although it is difficult to establish a direct causal link between the effects of the strategy and the economic development, scholars maintain that positive effects triggered by the WDS cannot be ignored.[644] Nevertheless, the proportionality issue is a controversial one, because there is no benchmark to decide whether the same effect will be achieved with fewer tax incentives. On the other hand, while there is economic growth in the western regions, the regional disparity between the western regions and the other parts of China is also increasing. Indeed, diverse factors contribute to the regional disparity, but the increased disparity reflects that the effectiveness of the tax incentives is limited.

Another issue is the possibility of achieving the objective with fewer tax incentives and the distortion effects are minimal. Except for the WDS, almost all the previous regional tax incentives in the SEZs for FDI have been abolished. Thus, there must be reasons that show that it is necessary to maintain tax incentives for the western regions, at least in a short term.[645] Actually, in China, the choice of instruments to achieve objects is not always free because it is always subject to the former experiences, and even cultural or systematic factors. As some authors pointed out, there is a path dependence for the adoption of tax incentives, just because the tax administration is familiar with the measure.[646] Furthermore, only when tax incentives are able to match the objective of promoting the state-supported sectors are they proportional. Therefore, it is difficult to conclude that the granting of tax incentives is necessary to achieve the goals. Furthermore, the volume of tax incentives still deserves discussion.

[643] Zheng and Fang, 'An Evaluation on the Effects of the Policy of the Great Campaign of Western Development of China in the First 10 Years-Based on the Kuznets Regional Inverted-U Theory'; Fan, Kanbur and Zhang, 'China's Regional Disparities: Experience and Policy'.
[644] Ibid.
[645] Bhajan S. Grewal and Abdullahi D. Ahmed, 'Is China's Western Region Development Strategy on Track? An assessment' (2011) 20 Journal of Contemporary China 161.
[646] Jinyu Ye and Derui Gu, 'Norms Review and Practrice Assessment of Tax Incentives: Principle of Proportionality as a Tool of Analysis' (2013) 35 Modern Law Science 178.

Consequently, the analysis comes down to a cost benefit analysis, which requires that the overall balance is positive with respect to the granting of tax incentives. It involves an economic analysis to measure the actual cost and benefit of the tax incentives, but the principle of equality plays an important role in determining the balance.[647] The economy is such a dynamic process that, at the beginning of designing the tax incentives, it is not precisely predictable how much tax revenue will be lost. In China's situation, eligible enterprises are qualified to apply for certain tax incentives, and thus it is the granting authority, i.e. the tax administration, that decides on the approval of tax incentives. In addition, as mentioned before, the major beneficiaries of the state-supported sectors are actually SOEs, compared with private enterprises or foreign enterprises. Under the WDS, the same situation arises, because the state-supported sectors are those related to public interest, such as manufacturing, public infrastructure, natural resources, etc. However, it cannot be denied that private and foreign enterprises play a significant role in stimulating economic growth, even bigger than some SOEs.[648] Hence, there is no guarantee that the granting of tax incentives to state-supported enterprises will definitely generate more benefits than providing the tax preferences to private or foreign enterprises.

In conclusion, it is difficult to provide an absolute answer on the compatibility assessment of whether the WDS may be exempted or not. In general, the object of the WDS is in line with the requirement of regional development in order to promote equality. The most important factor is that the State aid regime includes such an assessment process in its system to verify and control the abuse of tax incentives.

(2) General Block Exemption Regulation (GBER)

The general block exempted State aids include regional aid, small and medium-sized enterprise (SME) investment and employment aid, aid for environmental protection, and aid for research, development and innovation. The types of aid in this category are similar to non-actionable subsidies.

a. Tax incentives for SLEs

According to the GBER, SMEs play a decisive role in job creation and act as a factor of social stability and economic growth. However, they often have difficulties raising capital or loans,

[647] This section does not conduct an economic analysis without specific data.
[648] Curtis J Milhaupt and Wentong Zheng, 'Beyond Ownership: State Capitalism and the Chinese Firm' (2015) 103 Georgetown Law Journal 683-685.

especially for newly created SMEs, partially because their limited resources may often restrict their access to information. In order to facilitate the development of SMEs, it is reasonable to exempt certain categories of aid for SMEs.[649]

If enterprises are qualified as SLEs in China, they can enjoy both direct and indirect tax incentives. The current tendency is that the central government is strengthening the intensity of support for SLEs, not only through tax incentives but also by other means, such as looser conditions for loans from the bank. The background is that China's economy has entered a new stage, i.e. "the new normal", as the government announced.[650] "The new normal" means that the speed of growth of China's economy is slowing down from high speed to medium high speed; the economic structure is upgrading and the forces for economic growth are transforming from production factors and investment to innovation.[651] In such a context, in order to further liberate the economy, SLEs become a more and more important driving force for the economy. However, the slowing down of the economy means that SLEs need more assistance to thrive. Therefore, under the State aid regime, tax incentives for SLEs are likely to find justifications.

b. Tax incentives for high-tech enterprises

The GBER explained that, based on the past experience in the EU,[652] aid for research, development and innovation (R&D&I) can contribute to economic growth, strengthening competitiveness and boosting employment in the EU. Given the restricted R&D capabilities of

[649] The GBER defines that the category of SMEs is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million. In addition, the aid intensity is limited; for small enterprises, it shall not exceed 20% of the eligible costs and for medium-sized enterprises, it shall not exceed 10%. See Article 2 of Annex I, Commission regulation (ECU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (General Block Exemption Regulation, GBER) [2014] OJ L187/1.

[650] The "New Normal" was first completely explained by President Xi on the Asia-Pacific Economic Cooperation (APEC) Summit on 9 November 2014. Xinhua News (9 November 2014) <http://news.xinhuanet.com/world/2014-11/09/c_1113175964.htm> accessed 23 March 2015.

[651] Yang Yao, A New Normal, but with Robust Growth: China's Growth Prospects in the Next 10 Years, Think Tank 20: Growth, Convergence and Income Distribution: The Road from the Brisbane G-20 Summit < http://www.brookings.edu/~/media/Research/Files/Interactives/2014/thinktank20/chapters/tt20-china-growth-prospects-yao.pdf?la=en> accessed 15 April 2016; Angang Hu, *Embracing China's "New Normal", Why the Economy is Still on Track* (The Council on Foreign Relations 2015) < https://www.foreignaffairs.com/articles/china/2015-04-20/embracing-chinas-new-normal> accessed 15 April 2016.

[652] European Commission regulation (EC) No. 364/2004 amending Regulation (EC) No.70/2001 as regards the extension of its scope to include aid for research and development [2004] OJ L63/22.

both SMEs and large enterprises, market failures may prevent the market from reaching the optimal output, especially for SMEs who have difficulty in gaining access to new technological developments. Therefore, aid for R&D&I is exempted from the GBER.[653]

An obvious tax incentive for R&D&I is an additional deduction for R&D expenses as a means of support for high-tech enterprises. Except for this, tax incentives for high-tech enterprises, for the software industry and IC industry can be considered as stimulating the development of technology. Thus, if these enterprises conduct R&D&I activities, these activities will be block exempted under State aid law.

c. Tax incentives for environmental protection

One of the major objectives in the EU is to maintain sustainable development, and for that a high level of protection and improvement of the quality of the environment is necessary. However, the area of environmental protection is often confronted with market failures. Under normal market conditions, undertakings may not necessarily have an incentive to reduce their pollution due to the consideration of increasing their costs.[654] For these reasons, to create incentives for environmental protection, certain aids are considered compatible. This rationale applies to tax exemptions for energy-saving service enterprises in China. The analysis is the same as it is for non-actionable subsidies.

5.2.6 The WTO: remedies for actionable subsidies & the EU: remedies for unlawful State aid

5.2.6.1 The WTO: remedies for actionable subsidies

There are two levels of remedies provided for Members in the WTO when suffering from adverse effects of subsidies from other Members. At the DSB level, for prohibited subsidies, Members are recommended to withdraw the subsidies immediately; for actionable subsidies and non-actionable subsidies, Members are recommended to remove the adverse effects or withdraw the subsidies. Otherwise, the complaining Member can take countervailing measures against the subsidizing Member.

Since China's accession to the WTO, China has faced an increasing number of countervailing investigations from complaining Members about China's subsidy measures, especially tax

[653] The research and development project includes fundamental research, industrial research, and experimental development. See Article 25 aid for research and development projects, the GBER.
[654] See the economic analysis in Chapter 2.

incentives. After testing the selected current Chinese tax incentives against the subsidy rules in the WTO, some explanations can be offered. Indeed, certain tax incentives are not compatible with the WTO subsidy rules, and therefore China has to remove the adverse effects of those measures or withdraw the measures as remedies.

5.2.6.2 Remedies for unlawful State aid

The remedy is stricter in the State aid system. For unlawful State aid, which is granted without prior Commission authorization, the recovery is retroactive, meaning that the Member State has to recover the aid with interest. Although the testing of Chinese tax incentives against the State aid regime is hypothetical, it is valuable to see the differences in the available remedies. In terms of the Chinese tax incentives analyzed, if they cannot be justified as compatible State aid, it may be necessary for them to be recovered. For instance, these tax incentives include incentives for high-tech enterprises, for software and IC industries, for animation enterprises, and for the CEZs, and the FTZ. The extent of the remedy is much more severe than its counterpart in the WTO. However, the remedies reflect the requirement that a level playing field has to be re-established prior to the granting of the aid. Although the testing is hypothetical, when taking creating a level playing field as the benchmark, China is likely to face stricter remedies.

5.3 Matrix of the testing results

This section lists two matrices to present the testing results. The first matrix 5.3.1 shows the compatibility of selected Chinese tax incentives with the WTO's ASCM. The testing results are listed according to the category of subsidies under the ASCM, i.e. prohibited subsidies, actionable subsidies, and non-actionable subsidies. Actionable subsidies are listed by the standard of specificity, including *de jure* specificity (enterprise or industry specificity), *de facto* specificity, and regional specificity. The second matrix 5.3.2 presents comparative testing results of the WTO's ASCM and EU State aid law. It demonstrates similarities and differences in results when testing the same Chinese tax incentives to two regimes. This matrix classifies tax incentives according to specificity as well. The comparison reveals that certain tax incentives are likely to constitute both actionable subsidies and State aid. They include tax incentives for high-tech enterprises, for software industry and IC industry, for animation enterprises, and for energy-saving services enterprises; tax incentives for state-supported enterprises (SOEs); and tax incentives for autonomous regions, the WDS, the CEZs, and the FTZs. However, under EU State aid law, a number of tax incentives that are likely to constitute actionable subsidies under the ASCM, can be

justified and qualified as compatible State aid. This can be the case in respect of incentives for R&D, environmental protection, autonomous regions, and the development of the western region. In summary, the most controversial tax incentives are *de facto* incentives for SOEs; incentives for R&D activities demonstrated as support for high-tech enterprises, for software and IC industry, and for animation enterprises; and incentives for specific regions.

5.3.1 Matrix of the testing results with the ASCM of the WTO

	Export subsidies	**Import-substituting subsidies**
Prohibited subsidies	The general VAT refund is not an export subsidy	None
Actionable subsidies	**1. *De jure* specificity- Enterprise or industry specificity**	
	High-tech enterprises	**EIT incentives:** 15% CIT rate; exemption of income from the transfer of technology; additional deduction for R&D expenses; accelerated depreciation; special deductions for eligible investors in high-tech enterprises, etc.
	Software industry and IC industry	**EIT incentives:** (1) Tax exemptions for the first few years starting from the first profit-making year; (2) 15% CIT rate **VAT incentives:** (1) Regular taxpayer who sells the self-developed software products, after being taxed at 17% VAT, the actual VAT burden that surpasses 3% will be granted the incentive of immediate taxation and immediate refund; (2) Import VAT exemption for imported self-used production materials and consumables
	Energy-saving services enterprises	**EIT incentives:** Tax exemptions for the first three years starting from the first profit-making year and, from the fourth to the sixth year, CIT shall be cut half based on the 25% CIT rate **VAT incentives:**

		Exemption of VAT
	Animation enterprises	**VAT incentives:** (1) Immediate taxation and immediate refund of VAT; (2) Exemption of import VAT
Actionable subsidies	Small and low profit enterprises (SLEs) Justified by Article 2.1 (b) of the ASCM **Non-specific**	**EIT incentives:** (3) 20% CIT rate (4) The taxable income was calculated as 50% of the annual income, and 20% EIT rate **VAT incentives:** Exemption of VAT
	2. *De facto* specificity	
	Use of a subsidy program by a limited number of certain enterprise	Tax incentives for state-supported enterprises
	Predominant use by certain enterprises	SOEs are the main beneficiaries
	3. Regional specificity	
	Autonomous regions	May decide to reduce or exempt tax on the part of the enterprise income tax payable by an enterprise located in the said region
	Western Development Strategy (WDS)	**EIT incentives:** 15% CIT rate until 31st December 2020 **VAT incentives:** Exemption of import VAT
	Comprehensive experimental zones (CEZs): Hengqin, Pingtan, Qianhai	**EIT incentives:** 15% CIT rate until 31st December 2020 **VAT incentives:** Exemption of VAT
	Pilot Free Trade Zones (FTZs)	**EIT incentives:** CIT paid by installments over five years **VAT incentives:** Exemption of import VAT
	Assistance for R&D activities	Tax incentives for high-tech enterprises

Non-actionable subsidies	Assistance to disadvantaged regions	Tax incentives for autonomous regions and for the WDS
	Assistance for adapting infrastructure to new environmental requirements	Tax incentives for energy-saving services enterprises

5.3.2 Matrix of the comparable testing results

	Chinese tax incentives	**Subsidies in the WTO**	**EU State aid**
	General VAT refund	No subsidy	No State aid
Industry or enterprise specific/ selective	Tax incentives for high-tech enterprises; for software industry and IC industry; for animation enterprises; and for energy-saving services enterprises	Actionable subsidies with industry or enterprise specificity	State aid with material selectivity
		Non-actionable subsidies (invalid): (1) R&D activities (2) Environmental protection activities	***Compatible State aid:*** ***(1) R&D&I*** ***(2) Environmental protection activities***
	Tax incentives for SLEs	Non-specific: No subsidy	Compatible State aid
	Tax incentives for state-supported enterprises SOEs as the main beneficiaries	Actionable subsidies with *de facto* specificity	State aid with material selectivity
Regional specific/ selective	Tax incentives for autonomous regions, the WDS, the CEZs, and the FTZs	Actionable subsidies with regional specificity	State aid with regional selectivity
		Non-actionable subsidies (invalid): autonomous regions and the WDS	***Compatible State aid: autonomous regions and the WDS***

Remedies		DSB level: members are recommended to withdraw the subsidy or remove the adverse effects Domestic level: countervailing measures	Unlawful State aid shall be recovered with interest

5.4 Reviewing the comparable testing with benchmarks

5.4.1 Reviewing with the external benchmark

As introduced in Chapter 2 and Chapter 3, in order to analyze the status and problems of Chinese tax incentives, the research has established two benchmarks: the external benchmark and the internal one. The comparable testing conducted earlier was on the basis of the external benchmark, namely the subsidy rules in the WTO and EU State aid law. With the testing results of both systems, it is easier to review them against the general benchmark, i.e. the common object and purpose of the two systems which is the creation of a level playing field in the market. It has to be emphasized that the external benchmark serves here as a standard to evaluate the testing results, so it is not necessary to test Chinese tax incentives again following previous testing steps according to the external benchmark.

Under the external benchmark, the question to be answered is of whether the selected Chinese tax incentives cause distortions to the creation and maintenance of a level playing field in the international trade market. Reviewing the testing results, it is clear that, according to the criteria of the ASCM, certain Chinese tax incentives indeed constitute actionable subsidies. This is the case in respect of tax incentives for high-tech enterprises, for software industry and IC industry, for animation enterprises, for energy-saving services enterprises, for autonomous regions, the WDS, the CEZs, and the FTZs. The subsidies qualified as actionable subsidies, particularly those that are *de facto* specific, actually grant advantages to specific beneficiaries. The most problematic tax incentives are those designed for state-supported industries but *de facto* benefit the SOEs. They are not fair to other investors, such as private or foreign enterprises. The same rational applies to all above mentioned specific tax incentives, since these tax incentives only grant benefits to designated beneficiaries, which enable them to enjoy more advantages than other non-beneficiaries

in the same market. Therefore, when testing against the external benchmark, these specific tax incentives will most likely harm fair competition in the market.[655]

The testing results also demonstrate that EU State aid law provides different perspectives. In the hypothetical testing, tax incentives for R&D, environmental protection, autonomous regions, and the development of the western region can likely be justified and therefore be qualified as compatible State aid if certain conditions or assessment procedures are fulfilled. It appears that the State aid regime takes into account more scenarios regardless the distortive effects of tax measures.

The differences of the testing results have been evaluated on the basis of the external benchmark itself. As analyzed in Chapter 3, the concept of a level playing field is a reflection of the principle of equality, which requires equal treatment of enterprises with equal status, but different treatment of enterprises with a different status. It has been demonstrated that the EU State aid regime embeds this concept in its lawmaking. For example, regional aid is provided in disadvantaged regions and can be justified as a means to realize a level playing field. Although the above-mentioned tax incentives may have distortive effects, they can be justified by their objectives which are in line with the interest of the common market. In this way, different situations are treated differently. Moreover, the State aid regime has designed a strict ex-ante assessment to verify the compatibility of the aid measures. Thus, on the issue of tax incentives, compared to the testing under the WTO rules, the EU State aid system includes better ways to realize the object and purpose of creating a level playing field.

To conclude, the testing results expose problems existing in relation to Chinese tax incentives with respect to trade effects in the international trade market. Nevertheless, the comparative testing with the EU State aid system offers another perspective to consider this issue. Whether the relevant Chinese tax incentives cause distortions to international trade depends on the evaluation against the external benchmark. It is inspiring to see that, under the EU State aid regime, although some tax incentives have distortive effects, they can nevertheless be justified in order to realize a level playing field.

[655] See the economic analysis in Chapter 2.

5.4.2 Reviewing with the internal benchmark

As a Member of the WTO, China has an obligation to ensure that its measures are in line with the requirements of the ASCM. However, granting tax incentives is also a matter of the tax sovereignty of China. External control is necessary, but it is also important to view those tax incentives from China's own perspective.

On the one hand, as analyzed above, the internal benchmark shares the same essence of the external benchmark. In the context of reviewing the testing results against the internal benchmark, it must be noted that the internal benchmark has been based on s the same inspiration as the external benchmark. To achieve a level playing field, certain tax incentives could be justified. The most obvious incentives that could be justified because of the objective, are regional tax incentives. To be more specific, regional tax incentives that are aimed at decreasing regional disparity within China, if they fulfill certain conditions, can be exempted from being considered harmful subsidies. Thus, tax incentives adopted to support the national policy for supporting less-developed autonomous regions and western regions may be justified by the internal benchmark itself. This rationale is the same as the rationale applied in the context of the EU State aid system.

On the other hand, the evaluation of the internal benchmark reflects deeper problems of some selected Chinese tax incentives in respect of the creation of a level playing field in China's domestic market. As discussed in Chapter 4, China has a special status compared to other Members of the WTO since it has adopted a socialist market economy. The starting point to review the compatibility of Chinese tax incentives is then different from the review as it would be carried out for a typical western market economy. With respect to the issue of SOEs, the fact that they are the main beneficiaries of certain tax incentives is not only caused by tax incentives themselves, but it also has its origin in China's socialist system. The socialist system has determined that public ownership is the leading force of the economy and thus key industries are owned and operated by the state. There is no free market access for private or foreign enterprises to enter these industries, the most of which are state-supported industries. On the other hand, China is reforming the relationship between the government and the market so that there is more liberalization of the market with less governmental control. For instance, the establishment of the FTZs is a pioneer to experiment with a more liberalized market economy. Within the FTZs, there are only a few tax incentives, as the government tries to avoid causing new distortions. Therefore, taking into account the factual relationship between the government and the market in China, the evaluation under the

internal benchmark actually implies deeper problems of Chinese tax incentives. Even if these specific tax incentives are terminated in China right now, the tension with the WTO's subsidy rules will continue. The reason is that the relationship between the government and the market in China differs from the common one in the WTO. The lack of market access and lack of legal control over the granting of tax incentives have become the true obstacles to the creation of a level playing field in China's domestic market.

In summary, reviewing from China's domestic perspective, the creation of a level playing field should be the trend of the reform, because specific tax incentives can actually harm fair competition. However, the concept and interpretation of a level playing field is a complicated issue, since China also has its own political, economic, and cultural situations. Some tax incentives, such as those for less developed regions, for high-tech enterprises, and for energy-saving enterprises could be justified in order to create a level playing field in China. Moreover, it is China's state-oriented attitude towards tax incentives that impedes the realization of a level playing field in China.

5.5 Conclusion

After testing against both external and internal benchmarks, certain Chinese tax incentives are likely to constitute subsidies, and probably actionable subsidies, under the ASCM in the WTO. Considering their industry or enterprise specificity, they are tax incentives for high-tech enterprises, for the software industry and IC industry, for animation enterprises, and energy-saving service enterprises. With respect to their regional specificity, there are tax incentives for autonomous regions, the WDS, the CEZs, and the FTZs. Moreover, SOEs in China are *de facto* the main beneficiaries of the tax incentives for state-encouraged public infrastructure facility projects. Nevertheless, it is interesting to see that, based on the common object and purpose, comparable testing under the EU State aid regime presents different consequences, especially with respect to compatible measures. Some actionable subsidies are exempted from the State aid regulation once required conditions are satisfied, including tax incentives for R&D activities in high-tech enterprises, the software industry and IC industry, for energy-saving services enterprises, and for autonomous regions and the WDS. The external benchmark of a level playing field contributes to the evaluation of the differences. In order to realize a level playing field, tax incentives for certain

industries or regions are functional to improve equality, such as regional tax incentives in less-developed regions and tax reductions for SLEs.

The internal benchmark in China shares the same essence with the external benchmark for the interpretation of a level playing field for competition. Both of the benchmarks should take into account the principle of equality and the principle of proportionality. Under these criteria, tax incentives for regional disparities, i.e. for autonomous regions and the WDS, and tax incentives for supporting R&D activities in high-tech enterprises, for encouraging estimated effects of environmental protection by energy-saving service enterprises, can be justified. However, it is not argued that China can abuse the differences in the systems as excuses not to fulfill its international obligations. Another implication from the internal benchmark is that China has its own system with regard to the relationship between the government and the market. However, its state-oriented attitude towards tax incentives and the lack of legal control over tax incentives become obstacles to the creation of a level playing field in China's domestic market. These could be tensions between China and the WTO's subsidy rules and EU State aid.

In conclusion, it is necessary to examine the deeper tensions behind the comparative testing results. It is therefore helpful to highlight China's attitude towards tax incentives, and to make recommendations for China's position in international trade. In addition, it contributes to a further understanding of the WTO perspective towards taxation based on the comparative studies.

Chapter 6 The Origins of the Differences in the Testing Results

6.1 Introduction

The testing results in Chapter 5 demonstrate that certain Chinese tax incentives are likely to constitute actionable subsidies under WTO rules or State aid under EU law. This is the case in respect of tax incentives for high-tech enterprises such as software industry, IC industry, and energy-saving service enterprises, SOEs, and specific regions. The deeper reason for the measures to be identified as subsidies or State aid is probably due to tensions between the Chinese system and the international or the EU standards. Once the tensions exist, such incompatibility of the Chinese tax incentives with the WTO subsidy rules is likely to continue. Therefore, this chapter aims to analyze the origins of the tensions between the Chinese system and the Western system (the capitalist system of most of the WTO Members and EU Member States), in order to look for possibilities to alleviate the tensions. On the other hand, it intends to identify opportunities for the WTO in order to improve its system, especially when dealing with Chinese tax incentives, against the background of EU State aid law.

It is necessary to provide explanations and delimitations of some terms in order to limit the discussion to the research questions. As explained in previous chapters, this research does not aim at triggering arguments on ideologies, but it intends to present differences between the two categories of systems in China and the major Members of the WTO. Considering the relationship between the government and the market, China is a more state-oriented country. In contrast, the majority of the WTO members are market-oriented countries.[656] Thus, this research regards the major WTO Members as the West, in order to distinguish the West from China. The EU is also a Member of the WTO. Although the EU has its own path with regard to the development of State aid law, it shares common objectives and purposes with the WTO's subsidy rules on creating a level playing field for trade and investment. The integration levels differ in the EU and the WTO, but the EU State aid law functions under the principles of a market economy,[657] and therefore it could also be considered as the West when it is compared to China. In this research, the West particularly includes European countries, the United States, and other mainly English-speaking

[656] According to the relationship between the state and the market, there are few socialist countries in the WTO. There are four official socialist countries in the World, namely, China, Cuba, North Korea, and Vietnam. Cuba and North Korea accessed the WTO in 1995 when they were still in the system of a planned economy. Vietnam accessed the WTO in 2006.

[657] See Section 3.2.4 and 3.5.3 in Chapter 3.

countries.[658] This chapter first analyzes the tensions between China and the West in relation to granting tax incentives. Subsequently, it explores the origins of the differences between China and the West from a historical, economic, and cultural perspective. Afterwards, it looks for the possibilities of creating a common platform for both China and the West under the WTO's subsidy framework.

6.2 Tensions between Chinese tax incentives and the Western treatment of taxation

6.2.1 China: state-oriented attitude towards taxation vs. the West: taxation for public finance

China has a state-oriented attitude towards the granting of tax incentives. As commented by Cao (2009), the general object and purpose of taxation in China is to serve the state's function in relation to income, expenditure, reallocation of revenue, and administration.[659] The state plays an essential role in the allocation of public goods or social products. Accordingly, with respect to the granting of tax incentives, the Chinese government does not consider it as an intervention into the market but a way of macro-economic control that can realize the state's function.[660]

In comparison, the function of taxation in the West is different from its counterpart in China. Most Members of the WTO adopt the fundamental theories of public finance to serve as the basis of taxation, which maintains that taxation finances the supply of public goods. Taxation aims to provide public goods that the market cannot provide efficiently, thus focusing on the stabilization of economic activity, redistribution of income and wealth, and the allocation of resources.[661] Therefore, the starting point of the granting and control of tax incentives between China and the West are different. They present tensions between two different attitudes.

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[658] The WTO and the EU also contains Members of former Soviet Union countries that have experienced transition from a socialist system to a market system. However, this research distinguishes China from the West in general. The aim is to show that the starting point or background of China's attitude towards tax incentives is different from the WTO and the EU. Thus, the research does not discuss reference from those former Soviet Union countries.

[659] Cao, *Differentiation of the Generation on the Modern Tax Law, Pole Analysis and Case Commentaries of the Background Elements for China and the United States* 80-87 (in Chinese).

[660] The function of taxation in China is originally based on the economic theory of Karl Marx. Auyeung, 'Taxation Trends and Issues in the People's Republic of China: 1949 to 2006'.

[661] Richard Abel Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill 1973).

Matrix of the differences between the function of taxation in China and the West

Taxation	China	The West
Object and purpose	To realize the state's function	To realize the function of the public needs (public finance)
Subject	The state and the society	The government and the market
Object	Social product	Public product
Form	The state's allocation activity	The government's expenditure and administration
Function	The state's function of income, expenditure, reallocation of revenue, and administration	The stabilization of economic activity, redistribution of income and wealth, and the allocation of resources

6.2.2 China: the lack of internal legal control over the granting of Chinese tax incentives vs. the West: instrumentality controlled by the rule of law

The granting of Chinese tax incentives lacks an internal legal control, including legal assessment and remedies. It is common for governments to use tax incentives as instruments to achieve policy goals. Some authors consider the phenomenon as legislative instrumentality, i.e. employing the law as an instrument or means to achieve policy goals or ends.[662] However, if the government only uses the law as a technique or a means to implement policy goals, this can easily turn to instrumentalism.[663] Without legal control, such instrumentalism tends to infringe the basic legal principles of equality, certainty, and justice by causing unjustified discrimination.[664] Therefore, under the WTO framework, such governmental actions are regarded as interference into the market, and thus should be restricted by the law.[665] The subsidy system in the WTO provides for legal control over governmental activities. EU State aid law shares the same rationale.

The Chinese government also has an instrumentalist attitude towards the use of tax incentives, namely adopting tax incentives to achieve certain economic or social goals. Nevertheless, such an

[662] Hans Gribnau, 'Legislative Instrumentalism vs. Legal Principles in Tax' (2013) 16 Coventry Law Journal 92-93; Brian Z. Tamanaha, Laurien Talsma and Daphne van Mierlo, *The Perils of Pervasive Legal Instrumentalism* (Wolf Legal Publishers 2006).
[663] Robert S. Summers, *Instrumentalism and American Legal Theory* (Cornell University Press 1982) 59; Lon L. Fuller, 'Means and Ends' (2001) The Principles of Social Order : Selected Essays of Lon L Fuller 61.
[664] Gribnau, 'Legislative Instrumentalism vs. Legal Principles in Tax' 99-100.
[665] Ibid 92-93; Tamanaha, Talsma and Mierlo, *The Perils of Pervasive Legal Instrumentalism* 30-34.

instrumentalist use of tax incentives lacks a legal assessment and remedies according to the standard that is widely shared by the Western societies. Although there are concrete criteria stipulated in the EIT Law to approve different tax incentives to qualified enterprises, the granting or the issuing of tax incentives *per se* lacks a legal assessment, such as an ex-ante or ex-post assessment.[666] The evolution of tax incentives in China demonstrates that the Chinese government has realized the importance of integrating into the world economy by adapting to the international legal standards. However, it has not established an internal legal assessment system with regard to tax incentives nor a legal remedy system particularly for harms caused by tax incentives.

Moreover, there is no consensus in China to restrict the use of tax incentives as is the case in the West. Even when the Chinese government has realized the importance of reducing the adverse effects of tax incentives, it does not mean that it is due to a concern for infringing the legal order that is based on the Western approach.[667] Consequently, the tensions with the WTO will continue if adequate legal control is lacking in relation to the tax incentives in China.

6.3 The West: the origin of the Western treatment of tax incentives as subsidies

The starting point to depict the issue is the acknowledgement that the creation of the WTO and the EU *per se* is an outcome of a capitalist system. As analyzed in Chapter 2, with the expansion of international trade, in order to seek more profits and interests with a common perspective, more and more countries realize the importance of trade liberalization and the formation of the international market.[668] Hence, the GATT, the predecessor of the WTO was established to reduce trade barriers and to level the playing field.[669] This is also confirmed in the object and purpose of the WTO, which was discussed in Chapter 3.[670] Therefore, all the rules designed in the WTO are

[666] Xuhong Li, *Legal Analysis of Tax Expenditure System* (Law Press 2012) 129-132 (in Chinese); Howell H. Zee, Janet G. Stotsky and Eduardo Ley, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries' (2002) 30 World Development 1497.

[667] In 2014, on the Fourth Plenary Session of the Eighteenth Central Committee of the Chinese Communist Party (CCP), it was conveyed that the general target for next stage of the reform was to form a system serving "the socialist rule of law with Chinese characteristics and build a country under the socialist rule of law". See Randall Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' (2015) 7 Hague Journal on the Rule of Law 49-74; Sanzhu Zhu, 'Socialist Rule of Law in the 21th Century China' (2015) 7 Hague Journal on the Rule of Law 75-81.

[668] See Section 2.2.1 premise in Chapter 2.

[669] Kyle W. Bagwell and Robert W. Staiger, *The Economics of the World Trading System* (MIT Press 2002) 43-48.

[670] See Section 3.2.4 external benchmark: the creation of a level playing field based on the common object and purpose of the WTO and the EU in Chapter 3.

rules associated with the development of capitalism, the basis of which is efficiency and equity in the market.[671] The EU has a further integration level on the establishment of a single market.[672] However, this is also an outcome of the capitalist development. The economic rationale behind the single market is also efficiency and equity.

In order to analyze the reasons for forming such a relationship between the market and the government in the context of the development of capitalism, this chapter first introduces a historical review on the West briefly. The current rules in the WTO reflect the attitude of most Western countries towards the market. However, this is still in a dynamic process. From a historical and sociological perspective, the history of capitalism can be divided into different stages. Although the classification differs according to different criteria, following a chronological order, capitalism has experienced a period of growth.[673] The research does not aim at becoming entangled in the debates on the classification. The marking of several crucial events and the thoughts associated with them aims to present the transition of the relationship between the market and the government. To limit the scope of the discussion, a time span is presented. This part only covers the period from the origin of capitalism in Europe in the early 16th century when international trade became important to the time of the establishment of WTO in the 21st century. It selects representative scholars and their thoughts in their time as a means of presenting the origins of the Western treatment of tax incentives.

6.3.1 The market-oriented system

6.3.1.1 The evolution of the relationship between the market and the government reflected by economic thoughts

(1) Early 16th Century: Adam Smith

The modern form of Capitalist activities can be traced back to the early 16th century in early modern Venice, Genoa, and Pisa in the Mediterranean region.[674] Later on, England and the

[671] See Section 2.2.1 premise in Chapter 2.
[672] Chris J. Bickerton, *European Integration: From Nation-States to Member States* (Oxfrod University Press 2012) 8-10.
[673] For instances, Marxists classify the evolution of capitalism into agrarian capitalism, merchant capitalism, industrial capitalism, and modern capitalism. It is the view of major Marxists, such as Rudolf Hilferding, Ernest Mandel, Paul Sweezy, etc. See Larry Neal and Jeffrey G. Williamson, 'The Cambridge History of Capitalism. Volume 1, The Rise of Capitalism: from Ancient Origins to 1848' (2014) 1-23.
[674] Ibid.

Netherlands also commenced with similar business activities.[675] Most historians called this time a mercantilism period, when commercial activities in those countries were in the form of trade, aiming for profits. This period was associated with the geographic exploration of foreign lands by merchant traders at the same time.[676] Behind the geographic exploration and trade was the support from the ruling class of the countries who were eager for the strengthening of power and returns from capital investment.[677]

However, mercantilism encountered criticism from economists. The main representative was Adam Smith (1723-1790) who doubted the mercantilist pattern of the state's regulation aiming to increase economic growth. Adam Smith's attitude towards national economic policy can be regarded as the origin shaping the relationship between the government and the market. He took economic growth as the fundamental goal of merchant countries, and thus any policy was evaluated according to this criterion. In his view, all governmental interventions were to divert economic activities, which could restrict the mobility of labor and the formation of new markets, and thereby they caused adverse effects for economic growth. Therefore, he virtually objected to any form of governmental regulation of the market, but he advocated free competition to maximize economic growth.[678]

(2) Late 18th century to 19th century: David Ricardo

In the late 18th century, the first Industrial Revolution[679] changed the form of production completely by replacing the traditional handicraft skills with machines.[680] The large capital accumulated in the mercantilist stage made it possible to invest in factory production with

[675] The commercial activities expanded in the Low Countries in the coastal region of Western Europe, including the Netherlands, Belgium, and the surrounding area. See ibid.

[676] David Ormrod, *The Rise of Commercial Empires : England and the Netherlands in the Age of Mercantilism, 1650-1770* (Cambridge University Press 2003).

[677] The expansion of mercantilism was associated with colonization in this period. The examples were the British East India Company and the Dutch East India Company. They launched large-scale commercial activities in their colonies in that era. See ibid.

[678] W.J. Barber, *A History of Economic Thought* (Wesleyan University Press 2010) 23-51; Adam Smith and Jonathan B. Wight, 'An Inquiry into the Nature and Causes of the Wealth of Nations' (2007) .

[679] The first industrial revolution was the transition to new manufacturing processes from 1760 to 1840. It replaced humans and animals as the power sources of production with motors powered by fossil fuels (supplemented by waterpower and steam power). It was accompanied by the rise of the factory system. Moreover, it consisted of an increased scale in human organization of specialization and coordination at levels preindustrial groupings had rarely contemplated. See Peter N. Stearns, *The Industrial Revolution in World History* (Westview Press 2007) 6-7.

[680] P. M. Deane, *First Industrial Revolution (2nd Edition)* (Cambridge University Press 1980) 1-19.

machines, and thereafter productivity increased enormously. However, in order to deal with the surplus of products, more and more European countries were involved in international trade, thus accelerating the formation of the international market. As a result, international free trade gained more and more support.

David Ricardo's theory reflects the feature of this time. Like Smith, Ricardo (1772-1823) objected to the government's intervention into the economy and endorsed a self-regulating market system. He developed a theory of comparative advantage to explain the benefits of free international trade.[681] If each country had an absolute advantage in one product, it could produce greater quantities of one product more cheaply than the other country. Hence, trade between countries would accrue to all parties. This is also the theoretical origin of modern international trade.[682]

(3) The end of the 19th century to the early 20th century: Karl Marx

From the end of the 19th century to the early 20th century, most countries had completed the transformation to capitalism, which also stimulated the success of international trade, but triggered more conflicts.[683] The First World War happened between 1914 and 1918. It occurred against the background of economic, political, and military power races in Europe.[684] After the First World War, the German Empire, Russian Empire, Austro-Hungarian Empire, and the Ottoman Empire collapsed.[685] As a result, Europe was in ruins. From an economic perspective, the war exposed the disadvantages of a fully free market system at this time. Opposed to capitalism, Russia established the first communist state in the world based on Karl Marx's theory of socialism in 1917.[686]

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[681] John E. King, *Great Thinkers in Economics : David Ricardo* (Palgrave Macmillan 2013) 81-106; William J. Barber, 'A History of Economic Thought' (2009) 76-93. See also Section 1.4.1 of Chapter 1, Premise of international trade: traditional theory of comparative advantages.

[682] See Section 2.2.1.2 in Chapter 2.

[683] Larry Neal and others, *The Cambridge History of Capitalism. Volume 2, The Spread of Capitalism: From 1848 to the Present* (Cambridge University Press 2014) 1-21.

[684] There were two opposing alliances: the Allies, which consisted of the British Empire, France and the Russian Empire; the Central Powers included Germany and Austria-Hungary. More nations joined the war during the time: Italy, Japan, and the US joined the Allies, while the Ottoman Empire and Bulgaria joined the Central Powers. The Allies won the war. See Michael Howard, *The First World War: A Very Short Introduction* (Oxford University Press 2007) 37.

[685] Ibid 113-119.

[686] H. Bentley Jerry, G. Smith Bonnie and R. Kelley Donald, 'Europe and Russia in World History' in Jerry H. Bentley (ed), *The Oxford Handbook of World History Online* (The Oxford Handbook of World History

Karl Marx (1818-1883) was the representative who established socialist theories against capitalism from the perspectives of economics, history, politics, and philosophy, etc.[687] His main argument was that capitalism's decline was due to conflicts between classes. Instead, socialism, in the economic form of public ownership, would replace capitalism, mainly with private means of ownership, to resolve the problems that occurred in capitalist countries.[688] Although Marx's theories faced a lot of debates from the beginning until now, it was widely admitted that he pointed out that the consequences of the economic process under capitalism was not always entirely benevolent.[689]

(4) Early 20th century to the mid-20th century: John Maynard Keynes

After the First World War, from 1919 to 1929, most European countries started to repair their economies. Meanwhile, the US became an emerging strong power in the world.[690] However, the imbalances between the supply and demand of goods during world trade triggered the Great Depression in the 1930s.[691] Facing the economic crisis, governments of different countries tried various economic and political solutions to address the problems. In the US, Roosevelt initiated the New Deal by introducing more governmental intervention into the market for recovery.[692] In Europe, many governments who failed to solve the crisis turned to political changes. Dictatorship, such as Fascism and Nazism rose to power, especially in Germany.[693] Subsequently, the Second World War began in 1939 and ended in 1945. It was a devastating disaster for all nations, which caused a rethinking of the capitalist relationship between the government and the market.[694] Facing the discussion of the drawbacks of capitalism, the state played an increasing role to steer the economic growth.

Online, Oxford University Press 2012); Paul Bushkovitch, *A Concise History of Russia* (Cambridge University Press 2012) 293-317.

[687] Rolf Hosfeld and Bernard Heise, *Karl Marx : An Intellectual Biography* (Berghahn Books 2013).

[688] Michael Heinrich and Alexander Locascio, *An Introduction to the Three Volumes of Karl Marx's Capital* (NYU Press 2004); Shlomo Avineri, *The Social and Political Thought of Karl Marx* (Cambridge University Press 1972).

[689] Barber, *A History of Economic Thought* 117-123.

[690] Caitlin Corning, *World History a Short, Visual Introduction* (Project Muse 2015) 110-111.

[691] Eric Rauchway, *Great Depression and the New Deal* (Oxford University Press, USA 2008) 8-20.

[692] Ibid.

[693] Corning, *World History a Short, Visual Introduction* 111-113.

[694] Menno Spiering, *European Identity and the Second World War* (Palgrave Macmillan 2011) 2-19.

The most influential economist at this time was John Maynard Keynes (1883-1946). Having witnessed the Great Depression, Keynes held critical views towards the conventional laissez-faire theory, [695] which advocated that transactions between private parties should be free from governmental interference. He pointed out the enlargement of the government's functions as a practical means of avoiding the destruction of the capitalist economic system.[696] Additionally, he emphasized that governments had an important responsibility in relation to regulating the economic system in ways that would permit the market system to achieve its full potential.[697] Keynes's theory was considered to be a rectification of capitalism, because it laid the intellectual foundations for the economic stability of most Western countries by introducing governmental regulation into the market.[698] Most countries started to strengthen the state's regulation of the economy and recovered from the Second World War. Accordingly, the relationship between the government and the market evolved into a new stage that the government played an increasing role in correcting market failures.

(5) 1970s to the 21st century: Friedrich Hayek

The economic "stagflation"[699] in the 1970s led to a new round of debate on the relationship between the market and the government. More economists returned to advocating a more liberal market-oriented economic system. They blamed the "stagflation" to the over interference of the government and criticized the Keynesian economic model. The most active economists were Friedrich Hayek (1899-1992) and Milton Friedman (1912-2006). [700] Market capitalism gained more and more support after the collapse of the former Soviet Union.[701]

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[695] Laissez-faire is a French term generalizing the classical economic theories advocated by Adam Smith and David Ricardo. The main content was free market competition without governmental intervention. See Keynes, *The End of Laissez-faire*.

[696] Barber, *A History of Economic Thought* 223-226.

[697] Ibid.

[698] Roger Backhouse and Bradley W. Bateman, *Capitalist Revolutionary John Maynard Keynes* (Harvard University Press 2011) 21-46.

[699] The term "stagflation" is used to describe the situation of economic stagnation and comparatively high rates of inflation in the 1970s in the US and Europe. See A.S. Blinder, *Economic Policy and the Great Stagflation* (Elsevier Science 2013).

[700] F. A. Hayek and William Warren Bartley, *The Collected Works of Friedrich August Hayek* (Routledge 1988); Friedrich August Hayek, *The Road to Serfdom* (Routledge and Kegan Paul 1976); Milton Friedman and Rose D. Friedman, *Capitalism and Freedom* (University of Chicago Press 1982); Milton Friedman, *Monetarist Economics* (Basil Blackwell 1991).

[701] Neal and others, *The Cambridge History of Capitalism. Volume 2, The Spread of Capitalism: From 1848 to the Present* 384-425.

When entering into the 21st century of globalization, most capitalist economies had evolved into mixed economies including both market forces and governmental intervention, but the market played a decisive role in the allocation of resources, while the government intervened only when necessary.[702] This is the current format of the relationship, which acts as the context of the WTO and EU systems.

6.3.1.2 The origin of the state's function in relation to the market

As the relationship between the market and the government acts as the basis for understanding capitalism, it is necessary to understand the formation of the state in the West. Similar to the market, the idea of a modern state or government can also find its origin in capitalism.[703] The success of capitalism, as the historian Fernand Braudel (1985) concluded, was in the fact that it became a necessary part of the state and even the state itself.[704]

(1) Early 16th century: Niccolo Machiavelli

The image of a powerful state became evident since the early 16th century, as an opponent of the religious ruling in the Middle Ages.[705] Against the historical background of the Protestant Reformation[706] and the Renaissance,[707] the demand for a state aiming for business development

[702] Market-oriented capitalism suffered continuous criticism as well. There are always tensions between the balance of powers between the market and the government. A capitalist economy is in a dynamic process and therefore the relationship between the market and the government is still evolving. Terrence McDonough, *Contemporary Capitalism and Its Crises Social Structure of Accumulation Theory for the 21st century* (Cambridge University Press 2010); Ray Huang, *Capitalism and the 21st Century (Zi Ben Zhu Yi Yu Er Shi Yi Shi Ji)* (Jiuzhou 2012).

[703] Charles Tilly and others, *The Formation of National States in Western Europe* (Princeton University Press 1975); Stein Rokkan, Peter Flora and Stein Kuhnle, *State Formation, Nation-building, and Mass Politics in Europe : the Theory of Stein Rokkan : Based on His Collected Works* (Oxford University Press 1999).

[704] Fernand Braudel, *Civilization and Capitalism, 15th-18th Century* (Harper & Row 1985).

[705] Middle Ages lasted from the 5th century to the 15th century, which began with the collapse of the Western Roman Empire and merged into the Renaissance. Barbara H. Rosenwein, *A Short History of the Middle Ages* (University of Toronto Press 2009).

[706] The Protestant Reformation began in the 16th century. The movement began as a protest against perceived abuses in the medieval Catholic Church, but it soon spread to affect all of Europe. Since then, a series of changes took place in social, intellectual, economic, and political aspects in Europe. The most important was the developed idea of freedom of conscience, as opposed to the required Catholic orthodoxy of the medieval period. See G. R. Elton, *The Reformation, 1520-1559* (Cambridge University Press 1990); Eric Badertscher, *Protestant Reformation* (Great Neck Publishing 2009).

[707] The Renaissance lasted from the 14th century to the 17th century. It started as a cultural movement in Italy and spread throughout Europe. The most important idea since the Renaissance is its own invented version of humanism, which is embodied in art, literature, science, architecture, and politics. See Jerry Brotton, *Renaissance* (Oxford University Press 2006).

was increasing. Niccolo Machiavelli (1469-1527) was the first materialist who objected to religious beliefs applying in politics and advocated a powerful leader or even a state as the safeguard for the people instead of putting hopes on religious powers. [708] His materialist ideas of politics were considered as the first encouragement for risk taking and the formation of new orders.[709]

(2) 17th century: Thomas Hobbes and John Locke

In the 17th century, Thomas Hobbes (1588-1679) promoted the ideas of building a political community based on a "social contract", which was described in his book Leviathan.[710] In this book, Hobbes depicted a model of a modern state, a "Common-wealth", which advocated an absolute sovereignty and individual freedom. He held that the brute situation of the state of nature[711] could only be avoided by a unified and powerful government. The establishment of the state should be in the form of a "social contract". Citizens authorized and gave up right of government themselves to the government. In his opinion, there were three types of commonwealth and the best was monarchy, since, in this state, the private interest was the same as the public interest.[712] Hobbes further sketched the outline of a well-functioning state, which came closer to the modern government serving the civil society.[713]

John Locke (1632-1704) improved the theory of "social contract" by considering the state as the product of a social agreement by citizens who approved to transfer a part of their rights to the government. He thus claimed that foremost the government's function was to guarantee citizen's basic rights, especially the rights to property and liberty.[714] He was regarded as the founder of

[708] Miles J. Unger, *Machiavelli : A Biography* (Simon & Schuster 2011); Peter Samuel Donaldson, *Machiavelli and Mystery of State* (Cambridge University Press 1988).
[709] Peter Stacey, 'Roman Monarchy and the Renaissance Prince' (2007) .
[710] Thomas Hobbes, A. P. Martinich and Brian Battiste, *Leviathan* (Broadview Editions, Broadview 2011).
[711] According to Hobbes, human nature, such as desires and fear of violent death, will lead to fighting for scarce resources. It is the state of nature. Consequently, it results in a war of all against all. Ibid.
[712] Glen Newey, *Routledge Philosophy Guidebook to Hobbes and Leviathan* (Routledge Philosophy Guidebooks, Routledge 2008); F. C. Hood and Thomas Hobbes, *The Divine Politics of Thomas Hobbes : An Interpretation of Leviathan* (Clarendon Press 1964).
[713] Tom Sorell, 'The Cambridge Companion to Hobbes' (2006) 208-245.
[714] Christopher Pierson, *The Modern State* (Routledge 2004) 12.

modern liberalism and was the first to come up with the idea of a civil society to safeguard citizens' rights. Generally, the concept of a modern capitalist state started to be formulated since Locke.[715]

(3) 20th century: Max Weber

The development of a modern state is accompanied by the growth of capitalism, which requires a powerful government to serve for its expansion. [716] According to Max Weber (1864-1920), the modern state is a more general category of political associations. It has several features, including control of the means of violence, territoriality, sovereignty, constitutionality, impersonal power, the public bureaucracy, authority, and citizenship.[717] Behind the establishment of the government are the requirement for the protection of rights, individual freedom, and demand for liberation from religious control.[718] In the relationship between the market and the state, the state plays the role of protecting the market order and private ownership in the market.[719]

(4) 21st century: states for the protection of human rights

After the Second World War, more and more states in the West became concerned with the protection of human rights[720] as an indispensable function of the state, in order to prevent the resurgence of Fascism and Nazism.[721] To fulfill this function, the operation of the judiciary became necessary.[722] In Europe, the European Court of Human Rights (ECtHR) was established, which acts as an independent court supervising and safeguarding the state's responsibility towards

[715] J. H. Burns and Mark Goldie, *The Cambridge History of Political Thought, 1450-1700* (Cambridge University Press 1991) 616-652.
[716] Nasser Behnegar, 'Locke and the Sober Spirit of Capitalism' (2012) 49 Society 131.
[717] A. Anter and K. Tribe, *Max Weber's Theory of the Modern State: Origins, Structure and Significance* (Palgrave Macmillan UK 2014) 9-39; Pierson, *The Modern State* 5-6.
[718] Liang Zhiping, 'Explicating Law: A Comparative Perspective of Chinese and Western Legal Culture' (1989) 3 Journal of Chinese Law 55.
[719] Pierson, *The Modern State* 178-179.
[720] The concept of human rights subject to debate. The basic substantive content could refer to the Universal Declaration of Human Rights (1948). In this declaration, human rights generally include the right to life, freedom from torture, freedom from slavery, right to a fair trial, freedom of speech, freedom of thought, conscience, and religion, freedom of movement, etc. See http://www.un.org/en/universal-declaration-human-rights/, accessed 25 May 2016.
[721] Mikael Rask Madsen, 'International Human Rights and the Transformation of European Society: From 'Free Europe' to the Europe of Human Rights' in Mikael Rask Madsen and Chris Thonhill (eds), *Law and the Formation of Modern Europe: Perspectives from the Historical Sociology of Law* (Law and the Formation of Modern Europe: Perspectives from the Historical Sociology of Law, Cambridge University Press 2014) 245-246.
[722] Ibid.

individuals.[723] Some European countries evolved into modern welfare states,[724] which aimed at promoting the social and economic well-being of their citizens, such as the Netherlands, Germany, France, and the Nordic countries, etc.[725] States have developed the protection of human rights further, which leads to more governments orienting the market towards benefiting the well-being of citizens.[726]

6.3.1.3 Conclusion

According to the representative economic and political schools of thought in various stages of capitalist development in the West, it is evident to see that the capitalist development is a large-scale, worldwide, organizational, and dynamic process, so that the relationship between the market and the government is changing with the economic needs. However, from the perspective of the market, the market still dominates economic growth, which is the foundation of a market economy. It can be summarized that market competition and free international trade is the outcome of capitalism. The establishment of the whole WTO system is aimed at securing a legal order for the proper functioning of international trade and market competition. The EU has a similar function in relation to the creation of a single market. Meanwhile, from the perspective of the state, the formation of a modern state also reflects the requirement of the capitalist development in the West. It represents the protection of individual rights and serves the public good.

6.3.2 The rule of law

The WTO's system and EU State aid regime are both rule of law systems. Under the WTO's subsidy regime, in order to ensure the proper functioning of the market, it is necessary to introduce the rule of law in relation to governmental actions. The introduction of the rule of law system contributes to the creation of a level playing field for all the Members, which is in line with the object and purpose of the organization. The EU State aid law shares the same rationale. This section does not intend to offer a definition on the rule of law, but it tries to illustrate elements that

[723] Ibid 255.
[724] There is a huge variability of forms of welfare states due to different political, social, and economic contexts. Welfare states originated against the background of industrialization, the rise of capitalism, urbanization, and population growth in late 19th century. They normally present a combination of democracy, welfare, and capitalism. After the Second World War, a welfare state involves a transfer of funds form the state to services provided and to individuals directly. See Francis G. Castles and others, *The Oxford Handbook of the Welfare State* (Oxford University Press 2010) 4-5.
[725] Ibid.
[726] Ibid.

are generally conceived as basic components of the rule of law system. They serve as a basis to see the differences between China and the West with respect to the attitudes towards tax incentives.

In the West, regardless of the debates on the components, types, and degrees of the rule of law, the rule of law can generally be divided into two categories: the thin rule of law and the thick rule of law.[727] The thin rule of law normally entails basic elements of positive law, such as general, public, prospective, clear, consistent, capable of being followed, stable, and enforced.[728] The thick rule of law often embodies more morality and values compared to the thin one, such as justice, freedom, human rights, etc. It has more substantive values than the thin rule of law's focus on procedures.[729] As some authors pointed out, the thick theory requires a complete moral and political philosophy that confirms the rule of law as the rule of good law.[730] Therefore, the thick rule of law has a broader scope than the thin one, but it meets the minimum criteria of the thin theory.[731] In comparison, the thin theory is easier to embed into different contexts that have different cultures, values, and institutions.[732] The typical type of the rule of law in the modern West is a Liberal Democratic one, which entails free market capitalism, multiparty democracy, and a liberal interpretation of human rights.[733]

Nevertheless, both theories share the common sense that the threshold conditions of the rule of law is to restrain the arbitrary and inequitable use of state power and to protect individual rights.[734]

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[727] Christopher May, *The Rule of Law : the Common Sense of Global Politics* (Edward Elgar 2014) 33-56; Joseph Raz, *The Authority of Law : Essays on Law and Morality* (Clarendon Press 1979) 211; Robert S. Summers, 'A Formal Theory of the Rule of Law' (1993) 6 Ratio Juris 127.

[728] Different scholars have different lists for the elements of the rule of law. The representatives are Fuller (1976), Walker (1988), Raz (1979), Summers (1993), Fallon (1997), and Finnis (1980). Their lists share some common elements, but they also have differences. See May, *The Rule of Law : the Common Sense of Global Politics* 38-43; Randall Peerenboom, *China's Long March Toward Rule of Law* (Cambridge University Press 2002) 65-68; Lon Luvois Fuller, *The Morality of Law* (Yale University Press 1969); Geoffrey de Q. Walker, *The Rule of Law: Foundation of Constitutional Democracy* (Melbourne University Press 1988); Raz, *The Authority of Law : Essays on Law and Morality*; Summers, 'A Formal Theory of the Rule of Law'; Richard H. Fallon, '"The Rule of Law" as a Concept in Constitutional Discourse' (1997) 97 Columbia Law Review 1; John Finnis, *Natural Law and Natural Rights* (Clarendon Press 1980).

[729] May, *The Rule of Law : the Common Sense of Global Politics* 43-49.

[730] Raz, *The Authority of Law : Essays on Law and Morality* 211; Robert S. Summers, 'A Formal Theory of the Rule of Law' (1993) 6 Ratio Juris 135-138.

[731] Ibid.

[732] Peerenboom, *China's Long March Toward Rule of Law* 69-70.

[733] In Peerenboom's opinion, there are four types of rule of law, i.e. Liberal Democratic rule of law, Communitarian rule of law, Neo-authoritarian rule of law, and Statist Socialist rule of law. Ibid 103-109.

[734] The emphasis of the protection of individual rights thrived after the Enlightenment, which then became the values of the law. Bedner, 'An Elementary Approach to the Rule of Law'.

This is normally the starting point of the Western rule of law, which is also the context of the subsidy control system in the WTO and EU State aid law. Therefore, although governments use tax incentives as instruments to achieve policy goals, such instrumentality should be strictly controlled by the law.

6.3.3 The Western culture behind the development of the market

6.3.3.1 Max Weber

Max Weber was one of the most influential sociologists who officially promoted the term "the spirit of capitalism" and connected it to religious beliefs. In his book the Protestant Ethic and the Spirit of Capitalism, [735] he advocated that Protestantism, the religious beliefs involving Calvinism[736] and Puritanism,[737] had formed the basis of the spirit of capitalism and had even resulted in the rise of capitalism itself.[738] He connected the Puritan doctrine of the "calling" from God with the Predestination theory of Calvinism, thus justifying the belief that all Protestants should stick to the doctrine of the "calling". [739] It laid the foundation for materialism and individualism, which were key sources of capitalism. Additionally, he claimed that, in order to fulfill the "calling", it was encouraged to be rational and take risks to seek profits. Profit seeking continuously was not the means but the end itself. Thus, the employment of capital should be free from restriction. He upheld that Puritanism gave birth to Protestant ethic, because believers would organize tightly controlled, methodical-rational lives.[740]

[735] Max Weber and Stephen Kalberg, *The Protestant Ethic and the Spirit of Capitalism* (Blackwell 2002).
[736] In the 16th century, John Calvin (1509-1564) formulated a religious doctrine. In his view, God was an all-powerful and omniscient deity, far superior to all previous gods and separated from earthly mortals. God could express anger against sinful human beings. Moreover, God had "predestined" for all time, and only a minority were to be saved; the others were condemned to eternal damnation. Weber saw that the doctrine of predestination led to fatalism. Ibid xxx-xxxi.
[737] In the 17th century, believers in Calvinism reformulated the theories and upheld an ethos of "world mastery", thus devoting their lives to work and material success. Puritanism refers to the ascetic Protestant movements in the Netherlands, England, and North America oriented toward this asceticism in the 17th century. All Puritans organized their lives around work and a morally rigorous asceticism. Ibid.
[738] Weber and Kalberg, *The Protestant Ethic and the Spirit of Capitalism*.
[739] According to Protestantism, the "calling" is from God, and all Calvinists believe in the theory of predestination, which means that God has predetermined their fate. As Protestants, they believe that they are chosen by God, and therefore if they adhere to the "calling" of God, they will realize their good fate. See ibid.
[740] Ibid.

However, he also advocated asceticism and morality in the process of pursuing profits. In his opinion, Benjamin Franklin [741] (1706-1790) was the typical model of Puritan ideals, who endeavored to make profits in an honest way. The ideas of rationalism, seeking profit for its own sake, free competition, and adventurous spirit, and the like, eventually resulted in the development of capitalism.[742] When applying these ideas to business practice, it was reasonable to require fair competition in the market with less governmental restrictions. Additionally, in order to guarantee the environment for business activities to gain the maximum profits, it was necessary to establish the legal institutions and legal order to make sure that the competition is fair. Thus, except for competition in the market, cooperation and mutual trust were also important to achieve the goal.[743]

6.3.3.2 Discussion

It was emphasized at the beginning that this part does not aim to judge the different theories, but rather this part will present selected thoughts and their influences on the formation of the relationship between the market and the government in the West. However, after reviewing Weber's thoughts, it has to be admitted that they are the product of his time and thus they are shadowed by the limitations of the time. Although Weber's theories on the spirit of capitalism had a great influence on the understanding of capitalist developments, they suffer from much criticism as well.[744] It is not a convincing argument to conclude that the aforementioned capitalist spirit indeed caused the origin and development of capitalism, since it can be the other way around as well. Factors are always working mutually in relation to each other. Moreover, Weber promoted

[741] Benjamin Franklin was one of the founders of the US. See H. W. Brands, *The First American : the Life and Times of Benjamin Franklin* (Anchor Books 2002).

[742] Ibid. See also J Forbes Farmer, 'A Comparison of Some of the Themes of Irrationality, Illusion and Mystification Identified or Inferred by Karl Marx and Max Weber in Their Explanations of the Rise of Capitalism' (2012) 3 Journal of Sociological Research Pages 11; John Fantuzzo, 'A Course Between Bureaucracy and Charisma: A Pedagogical Reading of Max Weber's Social Theory' (2015) 49 Journal of Philosophy of Education 45; David Beetham, *Max Weber and the Theory of Modern Politics* (John Wiley & Sons 2013).

[743] Ibid.

[744] An important comment on Weber's theories is that it is difficult to establish a direct causal link between the capitalist spirit and the development of capitalism. Even if the former influenced the latter, this can hardly prove that the spirit is the only factor that determined the origin and prosperity of capitalism. In addition, both of their works were completed before the two World Wars, which results in a limitation of their views. See J. M. Barbalet, *Weber, Passion and Profits 'the Protestant Ethic and the Spirit of Capitalism' in Context* (Cambridge University Press 2008); Hector Menteith Robertson, *Aspects of the Rise of Economic Individualism : A Criticism of Max Weber and His School* (Cambridge University Press 1933).

his theories as a sociologist, views which could be distinct from those of economists, lawyers, and historians.

However, the focus here is to show that, even among the different schools of thought, there are some common cultural elements that are shared in depicting capitalism, namely, the respect for the market, fair competition, and cooperation. Moreover, the respect and requirement for legal order and the rule of law has its origin in capitalism as well. As commented by some authors, early capitalism had certain technological characteristics that determined its development over the centuries: the wide extension of credit, impersonal management, and the pooling of service facilities, such as transportation and telecommunications, legal services, and insurance. [745] All the three conditions rely on credit, which further requires the guarantee of the law. Therefore, a market economy in capitalism was established under the rule of law. This is the reason that, both the WTO and the EU have the common object and purpose of creating a level playing field in order to guarantee fair competition.[746]

6.3.4 Conclusion

As an outcome of the development of capitalism, the WTO and the EU represent the expansion of the market economy system in the West. Although the relationship between the market and the government is a dynamic process, the change itself reflects the increasing reliance on a well-functioning market system or the development of capitalism. Accordingly, the guarantee of the rule of law can also be regarded as the outcome of the capitalist culture. Thus, it contributes to the understanding in relation to the Western attitude toward tax incentives, i.e. although governments treat them as instruments to achieve governmental goals (instrumentality), they should also be controlled based on the rule of law. With respect to the function of taxation in the state, the public finance theory also has its origin in the development of capitalism. An important reason to use taxation to serve the public good of the state is that the state itself is created to fulfill the needs of the expansion of capitalism. Most importantly, the state is established to safeguard the rights of citizens. In conclusion, the respect for the market and the associated rules in the market have become a tradition, which is deeply rooted in Western culture.

[745] Huang, *Capitalism and the 21st Century (Zi Ben Zhu Yi Yu Er Shi Yi Shi Ji)*
[746] A level playing field is the external benchmark derived in Chapter 3.

6.4 China: the origin of China's attitude towards tax incentives

China has a distinct attitude toward its state-oriented style of using tax incentives or even, broadly speaking, of implementing a market economy and the rule of law, compared to the attitude in the West. As analyzed in the section addressing tensions,[747] tax incentives tend to be treated merely as policy instruments by the government without further consideration for legal control compared to the approach in the West. Many factors could result in such state-oriented characteristics. Similar to the analysis in the previous part, this part aimed to reveal the historical evolution in China, associated with various schools of thought, and to see how such state-oriented features are developed and how this differs from the West.

China is a country with a very long history. Before the origins of capitalism in the West in the 16th century, China had already developed an impressive civilization.[748] Historically, China is the only large country that has never come under the rule of the West, and it is the only region where the ancient and traditional cultures have been passed on and flourished up until modern times.[749] In order to have a clear view on the comparison with the capitalist approach to the relationship between the market and the government, it is better to review China's path according to its various historical periods. The most important division of historical periods can be seen between socialist China and traditional China, since, before the establishment of the People's Republic of China (PRC), China was mainly a feudal country.[750] Compared to most Western countries, China has never experienced a period of capitalism in a true sense. Politically, it transferred directly from a feudal or semi-feudal society into a socialist society.[751] This can already distinguish China from the most active countries in the WTO. Therefore, China has never been a market-oriented country and thus the starting point for China is different from the Western countries.

However, traditional China is also extremely different from socialist China, and therefore it is better to review the two periods separately in order to have a clear overview of the development of the state-oriented and instrumentalist attitudes towards tax incentives. This part aims to present

[747] See Section 6.2 in Chapter 6.
[748] Rossabi, *A History of China*.
[749] Becky Chiu and M. K. Lewis, *Reforming China's State-owned Enterprises and Banks* (Elgar 2006) 13; Linda Yueh, *China's Growth : the Making of An Economic Superpower* (Oxford University Press 2013).
[750] Most historians divide human societies into periods of slave society, feudal society, capitalist society, and socialist society according to the social and economic system. Marx also used feudalism to describe the economic situation before capitalism.
[751] Huang, *China, A Macro History*.

the different path China has taken and to discover the origins, both historically and culturally, of the aforementioned Chinese means of treating tax incentives. Different from the approach to introducing the development in the West in chronological order, this part first starts with the recent developments of China's state-oriented attitude in socialist China, because it refers to more recent times. In order to restrict the scope of the historical review, this part lists crucial elements in a generalized way.

Furthermore, when analyzing cultural issues involving the traditional Chinese thoughts, it is difficult to express the original and exact meaning of the ideas written in the ancient Chinese literature, because there are limits of the translations available and therefore the understanding of the literature.[752] The analysis is based on the meaning that has been traditionally accepted by the Chinese society and literature.

6.4.1 China's state-oriented attitude towards tax incentives

6.4.1.1 Socialist China

(1) 1949-1978

The state-oriented and instrumentalist characteristics of Chinese tax incentives date back to the establishment of the PRC, when China took over the socialist system. As introduced in Chapter 3 and Chapter 4, tax incentives were only adopted by the Chinese government after the Reform and Opening in 1978. The primary function of those tax incentives was to attract FDI, mainly to serve the goals of economic growth and opening to the world. Thus, they played the role of policy instruments from the beginning. With the progress of China's further integration into the world economy, China gradually realized the problems of favoring certain enterprises over others and started to regulate the use of tax incentives.

However, before the Reform and Opening in 1978, China had a closed-door period, except for its contact with the former Soviet Union before the 1960s. It experienced economic chaos and costly political campaigns.[753] Taxation in this closed period was endowed with the characteristics of the time.

[752] Wm Theodore de Bary and Yi-pao Mei, *Sources of Chinese Tradition* (Columbia University Press 1960) 3.
[753] See Section 4.2 in Chapter 4.

After the establishment of the PRC in 1949, the major tasks of the government were maintaining national unity, recovering the national economy, and remaining free from foreign interference.[754] Under the planned economy, the government had absolute control of business transactions. There was strong reliance on administrative commands to allocate resources and to set tasks.[755] With respect to taxation, the major task in this period was the unification of taxes to support military expenses and the recovery of the national economy, and thus the government implemented the centrally controlled fiscal system, i.e. unified revenue collection and unified spending.

After a short recovery of the economy, China started the first five-year plan,[756] in 1953, focusing on a rapid industrialization and transformation to a socialist economy. In order to build a socialist economy, reforms were mainly in relation to private and individual enterprises, transforming them into public or state-controlled enterprises. Thus, the government used taxation to assist this transformation by taxing private and commercial businesses more heavily than public and industrial businesses.[757] Additionally, another significant function of taxation was to raise revenue. The government found justifications in Marxism, which explained that taxes were the economic basis of the government machinery and of nothing else.[758] Under this theory, taxes were regarded as a device to raise revenue for socialist industrialization. Consequently, at the end of the first five-year plan, the socialist transformation was almost complete: the majority of the enterprises were public enterprises. The tax system was also simplified to accommodate the simplified economic structure for administrative cost considerations.[759] However, in the period of economic chaos and political campaigns from 1958 to 1976, the tax system almost collapsed. The function of taxation was further diminished.[760]

In summary, since the establishment of the PRC, the strong leadership of the government and the socialist system had resulted in the state-oriented features of taxation.

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[754] Qian and Wu, 'China's Transition to A Market Economy' 48; Gary Sigley, 'Chinese Governmentalities: Government, Governance and the Socialist Market Economy' (2006) 35 Economy and Society 498-504.
[755] Ibid.
[756] Under the planned economy, the government initiated a series of social and economic development plans.
[757] Auyeung, 'Taxation Trends and Issues in the People's Republic of China: 1949 to 2006' 250.
[758] Karl Marx and Friedrich Engels, *The Communist Manifesto* (Pluto 2008). See also Ibid.
[759] Li, *Taxation in the People's Republic of China* 12-13.
[760] Ibid 14.

(2) 1978-present

Since the introduction of a market economy in China after the Reform and Opening, market forces have grown rapidly with respect to trade and investment in China.[761] However, due to the socialist system itself, the state still has macro control over the whole economy, which typically results in more resources being available for the SOEs in the market. This state-oriented characteristic also results in tax incentives for SOEs.[762]

As some authors pointed out, centrally controlled SOEs are more powerful in persuading governments to provide them with preferential tax treatment via special tax rulings.[763] Centrally controlled SOEs are the government's main source of profits, because they are owned by the government. Additionally, considering their national economic importance, centrally controlled SOEs can always bargain with the government to get special tax treatment. For instance, in corporate reorganizations, SOEs normally try to persuade the government to grant tax exemptions for the gains earned on the transfer of assets and stock.[764] Thus, special rulings for the reorganization of those large SOEs are issued.[765] However, private and foreign enterprises are not in a position to benefit from such special tax treatment. Another example occurs in relation to the taxation of corporate consolidated groups. Generally, corporate groups are not allowed to compute tax liability on a consolidated basis or to offset losses against profits within a group due to the corporate income tax sharing between the central and the local governments.[766] Nevertheless, the central government has permitted such consolidation more and more often for large SOEs, especially centrally controlled SOEs, from 1994 to 2009.[767] This kind of consolidation tax treatment is also a result of lobbying by the SOEs. A further consequence, which disturbs the

[761] Kellee S. Tsai and Barry Naughton, 'State Capitalism and the Chinese Economic Miracle' in Barry Naughton and Kellee S. Tsai (eds), *State Capitalism, Institutional Adaption, and the Chinese Miracle* (State Capitalism, Institutional Adaption, and the Chinese Miracle, Cambridge University Press 2015) 1-2.
[762] See section 5.2.3.2.1 (2) b predominant use by certain enterprises: SOEs in Chapter 5.
[763] Cui, 'Taxation of State Owned Enterprises: A Review of Empirical Evidence from China' 109-131.
[764] Ibid.
[765] Ibid. Between 2000 to 2011, around 40 rulings were issued granting tax exemptions for these reorganizations.
[766] Cui, 'Taxation of State Owned Enterprises: A Review of Empirical Evidence from China' 120-122.
[767] Wenchuan Xia, 'Study on the Aggregated (Consolidated) Income Taxation of Enterprises' (2007) Taxation Research 44 (in Chinese).

market order is that inefficient SOEs continue to survive in the market due to the tax incentives, thereby resulting in unfair competition.[768]

In summary, the government takes it for granted that it may firstly satisfy the need of SOEs, even via unfair tax preferences, to guarantee the stability and prosperity of the national key industries. Additionally, SOEs are also a major revenue source of corporate income tax. Particularly, when encountering an economic crisis, the government tends to rescue SOEs as a priority by providing them with the largest support.[769] Nevertheless, as pointed out by some authors, ownership is not the essential reason for the government to grant tax incentives to SOEs, since many other countries also have SOEs.[770] The fundamental issue is that China has a state-oriented attitude towards the granting of tax incentives, even after many reforms of the relationship between the government and the market.

6.4.1.2 Traditional China: 16th century to 1949

Although the state-oriented characteristics of tax incentives is a current issue, a historical review helps to explore the influences of the past which can shed light on the present.

Traditional China covers the time of ancient China, Imperial China, and modern China before the establishment of the PRC.[771] Since the Qin dynasty in 221 BC, despite the changes of dynasties, China had been a unified country, which had developed a strong and systematic political and social structure through the governance of the emperor, with the emphasis on the centralization of powers.

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[768] Cui, 'Taxation of State Owned Enterprises: A Review of Empirical Evidence from China' 120-122.

[769] In order to confront the global economic crisis in 2008, the government issued a RMB 4 trillion fiscal stimulus package. However, most of these funds and bank loans were allocated to SOEs, while many private and foreign enterprises were seriously affected due to the weak markets. Hong Sheng and Nong Zhao, *China's State-owned Enterprises Nature, Performance and Reform* (World Scientific 2013).

[770] Curtis J. Milhaupt and Wentong Zheng, 'Reforming China's State-owned Enterprises: Institutions, Not Ownership' in Benjamin L. Liebman and Curtis J. Milhaupt (eds), *Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism* (Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism, Oxford University Press 2015) 119-202.

[771] Ancient China covers the time from 2070 BC to 221 BC before the Qin dynasty, which mainly includes three dynasties, the Xia dynasty, the Shang dynasty, and the Zhou dynasty; Imperial China is from the time of the Qin dynasty starting in 211 BC to the end of the Qing dynasty in 1911; Modern China refers to the establishment of the Republic of China in 1912 to the establishment of the PRC in 1949. This has been introduced in section 4.2 Chinese taxation from 1949 to 1978 in Chapter 4. See Huang, *China, A Macro History*; Loewe and Shaughnessy, 'The Cambridge History of Ancient China from the Origins of Civilization to 221 B.C'; MacFarquhar and Fairbank, *The Cambridge History of China: The People's Republic, Part 2: Revolutions within the Chinese Revolution, 1966-1982*; Zhuoyun, Baker and Duke, *China: A New Cultural History*.

To present a clear view on differences between the two paths, it is better to make the comparison of the same time period. The capitalist market and state emerged in the early 16th century, while China was under the Ming dynasty (1368-1644). With the further development of capitalism in the West, China was under the Qing dynasty (1644-1912), the last dynasty of Imperial China, and the Republic China (1912-1948), the period before the establishment of the PRC.

(1) The State

The meaning and the function of the "state" is very different in traditional China. As analyzed previously, the role of the state in the West is to guarantee citizens' basic rights and serves the public good. However, the traditional Chinese state is the emperor's state, i.e. all under heaven belong to the emperor.[772] The citizens are also considered to be subjects of the emperor. Hence, the role of the state is to guarantee the emperor's ruling and power.[773] This role of the state has its origin in ancient times.

The formation of the ancient Chinese state, as observed by some authors, was a result of the upper class's requirement to maintain a new social order. [774] The earliest development of state was greatly influenced by warfare and the traditions of the clan elders.[775] Therefore, originally, the state was not the representative of the public power, but it served for the conquest and control of clans.[776] From the Qin dynasty (221BC to 206 BC), when China was first unified as a whole country, the trend was to strengthen the power of the emperor at the central level, to maintain absolute rule and control over the country. During the entire period of Imperial China, regardless of the transition between dynasties and emperors, the most significant feature of the state was the centralization of powers at the hands of the emperor and the ruling class. In order to achieve the aim, the state was equipped with structured political, military, and fiscal systems for centralized management.[777]

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[772] Ray Huang, *Taxation and Governmental Finance in Sixteenth-Century Ming China* (Cambridge University Press 1974) 6-7.
[773] Ibid.
[774] Zhiping, 'Explicating Law: A Comparative Perspective of Chinese and Western Legal Culture' 89-90.
[775] Ibid.
[776] Ibid.
[777] Denis Twitchett, John K. Fairbank and Frederick W. Mote, *The Cambridge History of China Vol. 7, The Ming Dynasty, 1368-1644: Part 1* (Cambridge University Press 1988); Denis Twitchett, John K. Fairbank and Frederick W. Mote, *The Cambridge History of China Vol. 8, The Ming Dynasty, 1368-1644: Part 2* (Cambridge University Press 1998);Willard J. Peterson, Denis Crispin Twitchett and John King Fairbank, 'The Ch'ing Empire to 1800. Part 1 ' (2002)

When the West gradually developed capitalism, in China, the Ming dynasty (1368-1644) witnessed a great growth in Chinese civilization. The typical political feature of the Ming dynasty was a high degree of centralization. Since the founding of the dynasty, it had formed a strong, assertive, and politically centralized regime.[778] Accordingly, the emperor himself controlled the empire's finances as a whole. There was no clear distinction between the state's income and the emperor's personal income, vis-à-vis expenditure. Thus, it was difficult to distinguish between the emperor's personal spending from the state's expenditure. The ministry of revenue therefore developed into an Imperial accounting office.[779] Subsequently, the Qing dynasty (1644-1912) succeeded the former dynasties' tradition of political centralization, especially aiming to safeguard the minority's control over the country.[780]

Compared to the West in the same period, the political centralization was a significant factor to explain the state-oriented characteristics of the Chinese government. In the West, especially the Europe, before the development of capitalism, the countries were also feudal societies, which were under the rule of a king, but the power of the king was not as strong and centralized as the power of the emperor in China.[781] There was pressure from the aristocracy and the church, which were delegated decentralized powers from the king.[782] Such decentralized power was regarded as enabling the capitalist class to take the power and to establish a modern State.[783] Nevertheless, similar to the Western approach, the Chinese approach was also a dynamic process. For instance, China was not always a highly centralized state in modern times. After the end of Imperial China, the Republic period witnessed warlordism (1915-1928), the Sino-Japanese War (1937-1945), and

[778] Ibid.
[779] Huang, *Taxation and Governmental Finance in Sixteenth-Century Ming China* 1-17.
[780] Ibid.
[781] Cao, *Differentiation of the Generation on the Modern Tax Law, Pole Analysis and Case Commentaries of the Background Elements for China and the United States* 51-53.
[782] The divine right of kings refers to a political and religious doctrine that a monarch derives the right from the will of God. The King is not subject to the will of the people, the aristocracy, or the church. However, with the growth of powers in the aristocracy and the church, the rights of the king are decentralized. Hillay Zmora, *Monarchy, Aristocracy, and the State in Europe 1300-1800* (Routledge 2000).
[783] Ibid. Braudel, *Civilization and Capitalism, 15th-18th Century*; Neal and Williamson, 'The Cambridge History of Capitalism. Volume 1, The Rise of Capitalism: from Ancient Origins to 1848'.

the Chinese Civil War (1927-1949).[784] In that unstable period, it was difficult to maintain a strong centralized power by the government.

(2) The market

The market economy originated in the West. As introduced in the previous part, capitalism emerged in the 16th century, because the state initially took a rather supportive attitude towards business development. In contrast, the ruling class of China consecutively had a pro-agriculture and anti-commerce policy, i.e. encouraging agricultural development but restricting commerce. This was the basic economic policy adopted throughout the Imperial history of China. For emperors, it was very beneficial to take this approach for their rule to be sustained. The most significant reason was that China was an agricultural country, which had a self-sufficient agricultural economic system. On the one hand, it was necessary to maintain enough agricultural products to guarantee the basic supply for the operation of the country. On the other hand, due to the large geographical area of the empire, it was convenient for the emperor to govern and control the people if they were reliant on the land. In addition, farmers were normally not well educated, and therefore it was easier to unify them and control them.[785] Moreover, the development of commerce would result in the labor force having to compete with agriculture, and thus in the social hierarchy, merchants were normally ranked at the bottom with the lowest social status.[786]

Although in Ming dynasty commerce was very active in the coastal area, the main businesses were still operated or monopolized by the government. The more developed the small businesses were, the heavier the tax that was levied.[787] Even in the Qing dynasty when the emperor realized the importance of developing industries to cope with the Western forces after the Opium War,[788]

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[784] John K. Fairbank, ed., *The Cambridge History of China: Republican China, 1912-1949, Part 1*, vol 12 (Cambridge University Press 1983).

[785] Cao, *Differentiation of the Generation on the Modern Tax Law, Pole Analysis and Case Commentaries of the Background Elements for China and the United States* 55-60.

[786] Except the absolute position of the emperor at the highest level, the other people were classified into different classes according to a certain hierarchy. The order was scholar, farmer, artisan, and merchant. See Huang, *Taxation and Governmental Finance in Sixteenth-Century Ming China* 189-224.

[787] Ibid.

[788] The Opium Wars were two wars between the United Kingdom and the Qing dynasty on the issue of British trade in China and China's sovereignty. The First Opium War was between 1839 and 1842 and the Second Opium War was between 1856 and 1860. Before the wars, China was a closed country with limited trading with outside world. After the two wars, China was forced to open to foreign merchants. More than 80 treaty ports were established in China and foreign imports were exempted from internal taxes. John King

the major business areas and industries were owned and operated by the government. They were considered to be the prototype of the modern state-owned enterprises. [789] However, the existence of such commerce was also to serve the emperor's rule. The merchants were actually official merchants, whose interests were closely linked with the ruling class.[790] Without the existence of a free market, the state had a dominant role in every aspect of the economy.

To summarize, compared to the Western evolution of the relationship between the market and the government, traditional China took a very different path. Firstly, the concept of the state is very different from the one in the West. The state functions as the emperor's state, which has to fulfill the emperor's ruling first. It has formed a highly centralized political system to strengthen the emperor's and the state's power. Accordingly, with respect to taxation, there is no clear separation between the emperor's personal income and expenses and the state's expenditure. In addition, the state has a dominant role in the administration of the economy by adopting the pro-agriculture and anti-commerce policy. Consequently, there was no comparable development of commerce in China at that time, not to mention the formation of a free market. Thus, all the factors contribute to the understanding of China's state-oriented attitude towards a market economy system.

6.4.2 The lack of internal legal control over the granting of tax incentives

The function of law in China is different from the Western rule of law, or it is at least different from the Liberal Democratic rule of law. Of course, the concept and function of law has also evolved over time, but the instrumentalist characteristic of the Chinese tax incentives can find its origin in that evolution.

6.4.2.1 Socialist China

(1) 1949-1978

Before the Reform and Opening in 1978, Marxist legal theories had the dominant position. The instrumentalist feature may result from the doctrinal interpretation of Marxism, the dominant thoughts advocated by the government. Since the establishment of the PRC, Marxism was regarded

Fairbank and Denis Crispin Twitchett, *Late Ch'ing, 1800-1911. Part 1* (Cambridge University Press 1978) 163-212.

[789] J.T. Dreyer, *China's Political System: Modernization and Tradition* (Pearson Longman 2012); Benjamin A. Elman, 'Naval Warfare and the Refraction of China's Self-Strengthening Reforms into Scientific and Technological Failure, 1865-1895' (2004) 38 Modern Asian Studies 283.

[790] Cao, *Differentiation of the Generation on the Modern Tax Law, Pole Analysis and Case Commentaries of the Background Elements for China and the United States* 55-60.

as the national guiding ideology. However, it was difficult to conclude that China precisely transferred the original meaning of the theories, which were developed to deal with the circumstances of capitalist societies or at least industrial societies.[791] As an agricultural country at that time, China faced a challenge of combining the theories with its domestic situation. Therefore, some scholars recommended the application of those theories as doctrinal interpretations of classics, especially when applying those theories to justify economic growth in the context of ideological confrontations with the outside world.[792] For instance, according to Marx's historical materialism, production forces always determine the relations of production, and thus the mode of production is based on the level of production forces. On the other hand, relations of production contribute to the degree and types of the development of production forces. To be specific, the economy is the key element of a production force, while the cultural and institutional factors of the society belong to the superstructure.[793] However, at that time, this theory was simply interpreted as economic determinism, i.e. the economic level determined the superstructure. Consequently, it was taken for granted that law, as a part of the superstructure, should play a role that was subordinate to the economy, even as a means to achieve the economic end. Yu (1989) summarized it as legal pragmatism, which was visible in the following aspects: it overemphasized the instrumental function of law; it regarded law as an outcome of reality; it treated law as a servant of policy.[794] Thus, from the beginning, not only taxation, but also the legal system itself, functioned as instruments of the government.[795]

(2) 1978-present

After the Reform and Opening and the introduction of a market economy into China, China adopted the rule of law gradually. The rule of law was firstly acknowledged as a national policy in 1997 when the Chinese Communist Party (CCP) officially announced that it would be governing

[791] Barber, *A History of Economic Thought* 117-123.
[792] Xia Wang, *On Legal System of Tax Incentives: Perspective for the Normative and Legitimacy Requirements of Law* (Law Press 2012) 42-45 (in Chinese); Xingzhong Yu, 'Legal Pragmatism in the People's Republic of China' (1989) 3 Journal of Chinese Law 29; Peerenboom, *China's Long March Toward Rule of Law*.
[793] Heinrich and Locascio, *An Introduction to the Three Volumes of Karl Marx's Capital*;Karl Marx, *Capital : a critique of political economy* (Penguin ; New Left Review 1976); Avineri, *The Social and Political Thought of Karl Marx*; Melvin Miller Rader, *Marx's interpretation of history* (Oxford University Press 1979).
[794] Yu, 'Legal Pragmatism in the People's Republic of China' 39-49.
[795] Auyeung, 'Taxation Trends and Issues in the People's Republic of China: 1949 to 2006' 249.

the country according to law.[796] Since then, China was marching towards a socialist rule of law state, which was incorporated to the Constitution in 1999.[797] Subsequently, China implemented institutional reforms. For instance, the legislative reform emphasized the strengthening of the lawmaking function of the legislature and the quality of lawmaking. [798] Administrative reform focused on administration according to the law.[799] As a result, the role of the government has been limited. There is an increase in limiting the arbitrary acts of government and in protecting individual rights. [800] Judicial reform started with goals of judicial fairness and efficiency. [801] Moreover, reforms also aimed at enhancing the quality and professionalism of judges. There are attempts to increase the authority and independence of courts as well.[802] In addition, the state intensified legal education and legal services to propagate the rule of law culture. [803] Most importantly, the CCP adopted the rule of law as a guiding principle for the party in 2002, i.e. "ruling the country according to the law."[804]

In 2014, China reemphasized that the purpose of the legal reforms was to establish a socialist rule of law with Chinese characteristics.[805] There are five general principles: the leadership of the CCP, the supremacy of the interests of the people, the supremacy of the constitution and laws, the combing of the rule of law with the rule of virtue, and the need to find China's own path.[806] It seems that China is going further to establish a rule of law in more regimes, but it is not likely to be in the same way as the Liberal Democratic rule of law that is generally accepted by Western countries. The concept of "socialist rule of law with Chinese characteristics" clearly does not

[796] The rule of law was adopted in the 15th Central Committee of the CCP in 1997.
[797] The socialist rule of law was incorporated into the Constitution at the Second Plenary Session of the Ninth National People's Congress. It is stated in the Constitution: "rule the country according to law, establish a socialist rule of law state". See Young Nam Cho, "'Governing the Country according to the Law": China's Rule of Law Policy as Political Reform' (2014) 21 Journal of Internatioanl and Area Studies 21, 22.
[798] Ibid 26-27.
[799] The State Council issued the Decision on the Comprehensive Implementation of the Administration according to the Law in 1999, and the Implementing Outline on the Comprehensive Promotion of the Administration according to the Law in 2004. See ibid 22.
[800] Ibid. Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 66.
[801] The Supreme People's Court (SPC) has provided outlines on the reform of the people's courts every five years since 1999. See ibid.
[802] Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 68.
[803] Zhu, 'Socialist Rule of Law in the 21th Century China' 80-81.
[804] The 16th Central Committee of the CCP in 2002.
[805] See Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 74; Zhu, 'Socialist Rule of Law in the 21th Century China' 81.
[806] Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 58-63.

transplant or copy the Western format, but it will adapt the so-called "international best practices" to fit its own circumstances.[807]

With respect to tax incentives, previous analysis shows that different tax incentives serve different policy goals, which endows them with the characteristic of instrumentality for the government. However, even against the background of establishing a socialist rule of law, there is a lack of legal control over tax incentives. For instance, no specific law or regulation stipulates the legal procedure for granting tax incentives; there is no law on remedies for tax incentives, especially from the perspective of restricting the government's power; and there is no law on the allocation of powers between the body granting tax incentives and the supervision body, etc. Although in 2015 the SAT published a notice on all the official and effective tax incentives until 2015, it was only a list of tax incentives but not a regulation on tax incentives.[808] There are only regulations on restricting of the benefits of tax incentives enjoyed by taxpayers, but there is no regulation on how the government grants tax incentives.[809] To summarize, there is still a lack of legal control over tax incentives against the background of the great legal achievements that were accomplished under China's socialist rule of law.

6.4.2.2 Traditional China

Ancient China and Imperial China were under the rule of emperors. Although there were codified laws, the role of law was simply to serve the emperor governing the state and people. [810] The most influential classical legal theories in Ancient China include the Confucius rule by rituals (Li Zhi), and the Legalist rule by law (Fa Zhi).[811]

Rule by rituals emphasized ruling by the ruler's virtue and morality in order to achieve a humane and harmonious society. In Confucians' view, law was only punishment, which forced people to comply externally. However, rule by rituals would lead people become humane people of good character, thereby finally forming a harmonious society.[812] In contrast, the Legalist rule by law

[807] Ibid.
[808] The SAT notice [2015] No.73, Notice on the Issuing of the Code Directory of Tax Incentives, by the SAT, 29 October 2015.
[809] The SAT notice [2015] No.76, Notice on the Issuing of Administrative Regulation of Corporate Tax Incentives, by the SAT, 12 November 2015.
[810] Zhiping, 'Explicating Law: A Comparative Perspective of Chinese and Western Legal Culture' 89-90.
[811] Li Zhi and Fa Zhi are the Chinese pinyin.
[812] Peerenboom, *China's Long March Toward Rule of Law* 28-33.

advocated clearly codified laws that were publicly promulgated in order to strengthen the control of the ruler. However, such a legal theory was not the rule of law, but rather the rule by law, as observed by scholars.[813] Laws were merely utilized as tools of the rulers to impose punishment and exercise administration over the people, and even to govern the behavior of officials. As a result, the rulers themselves were exempted from the control of the law, because the authority of the law came directly from the rulers. [814] Both these classical theories had a great influence on the role of law in each dynasty of Imperial China. Despite their different opinions, they have one common feature and that is to serve for the ruling of the ruler.

Therefore, in traditional China, the law was mainly treated as an instrument to serve the interests of the emperor and the state, which was contrary to the Western fundamental idea of protecting individuals' rights against the state. Despite the large quantities of legal orders and codes issued in different dynasties, most of them were penal laws used to punish and govern the people or administrative laws for the control of the government.

In conclusion, the formation of the instrumentalist feature of tax incentives can find its origin in traditional China and the socialist period before the Reform and Opening. Compared to the Western tradition of the rule of law, China had a different path. Law was consecutively treated as instrument to fulfill the interests of the state rather than the interests of individuals. Thus, it contributes to understanding why the Chinese government was not used to take account of the granting of tax incentives for the legal control.

6.4.3 Cultural influences: Confucianism

Culture is another factor that can shed light on the different path China has taken. As commented by scholars, in traditional China, the law's instrumentalist character in China is closely linked with the state's function, which is paternalistic with respect to the relationship between the state and citizens.[815] The paternalistic state considers the interest of the state to be more important than individual rights. Hence, in such a paternalistic Chinese Imperial state, rulers always maintain that the interests of the state can be in harmony with individuals' interests.[816]

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[813] Ibid 33-34.
[814] Kenneth Winston, *The Internal Morality of Chinese Legalism* (Harvard University Press 2005); Zhiping, 'Explicating Law: A Comparative Perspective of Chinese and Western Legal Culture' 89-90.
[815] Peerenboom, *China's Long March Toward Rule of Law* 43-46.
[816] Ibid.

When addressing traditional China's paternalistic governments, the influence of Confucianism cannot be neglected. However, Confucianism is a very broad term, which contains a variety of theories, interpretations, and changes.[817] Moreover, Chinese culture itself is also an extremely broad concept that it is not equal to Confucianism *per se*.[818] It is hard to prove the direct causal link between Confucianism and the state's development or the formation of socialism, but the reciprocal influences of Confucian culture and the social changes should not be overlooked. It has to be admitted that no other individual in Chinese history has influenced the Chinese mind and character so deeply.[819] Nevertheless, through the long history of China, the original Confucius thoughts have already been changed a lot, and therefore the dominant Confucian culture in China, as commented by authors, is actually a mixed culture with diverse thoughts from different schools over the dynasties.[820]

Confucian thoughts involve many disciplines, but it is not the purpose of this chapter to address the entire philosophies. The aim here is to analyze the influence of the Confucian school of thought on the relationship between the state and the people, and the role of law as well. In addition, its influence on Chinese culture can also help to understand from another facet why China takes such a distinct path of development compared to the overall Western world.

6.4.3.1 An overview of Confucianism in traditional China

(1) Confucianism in general

Confucian thoughts formed in ancient China during the Warring Stats period (453-221 BC); the intensive influence of Confucianism in China had its roots in the Han dynasty (206 BC to 220 AD).[821] Since then, although the status of Confucianism experienced a fall and rise, Confucian

[817] Ronnie Littlejohn, 'Confucianism an introduction = Ru' (2011) xi-xvi; Paul R. Goldin, *Confucianism* (Acumen 2011) 1-6.
[818] Ibid.
[819] Bary and Mei, *Sources of Chinese Tradition* 17.
[820] Confucius' thoughts underwent changes. In Imperial China, there were later Confucianism, Neo-Confucianism, New Confucianism, and Western disciples of Confucianism, etc. Therefore, one cannot easily reach the conclusion that Confucianism *per se* has greatly influenced the Chinese culture. See Wm. Theodore de Bary, Wing-tsit Chan and Burton Watson, *Sources of Chinese tradition* (Columbia University Press 1960).
[821] The Han dynasty was the first dynasty that officially confirmed Confucianism as the state's sole authoritative philosophy. See ibid 161-164.

works and philosophies were passed on through the education and imperial examination system, which was the most important way to select governmental officials.[822]

Confucius' thoughts were mainly recorded in the books edited by his disciples.[823] In fact, the core of Confucian philosophies was about virtues and the most important virtue, according to Analects,[824] was humanity (Ren).[825] Based on this core morality belief, rituals (Li)[826] developed accordingly to direct people's behaviors.[827] However, the function of rituals was different from law at that time, since law was deemed to be used only as a punishment. Because Confucians believed that human beings have a character of self-cultivation, only virtue and ritual could allow people to cultivate better characters. The ultimate aim of Confucians was to create a peaceful world, which was to be realized through a step-by-step approach. The first step was to investigate things and, afterwards, one would be able to gain knowledge, make the intention sincere, rectify the heart, cultivate oneself, take care of the family, order the state, and eventually bring peace to the world.[828] Hence, the key function of the government was to correct people's minds and to guide people to

[822] Benjamin A. Elman, *A Cultural History of Civil Examinations in Late Imperial China* (University of California Press 2000).

[823] The Four Books and Five Classics are considered as classic texts of Confucianism. The Four Books are: Great Learning, Doctrine of the Mean, Analects, Mencius; the Five Classics include: Classic of Poetry, Book of Documents, Book of Rites, Book of Changes, and Spring and Autumn Annals. See Michael Nylan, 'The Five "Confucian" Classics' (2001) .

[824] Analects is one of the Five Classics of the classic texts of Confucianism, but it has a central status among all the texts. Ibid.

[825] Ren is the Chinese pinyin.

[826] Chinese pin yin.

[827] The character of rituals is controversial. Some scholars consider rituals as a code of conduct for the guidance and restriction of behavior. However, others claim that it is just a format of embodiment of virtues that lead people to self-cultivation, rather than the mere function of rules. See Herbert Fingarette, *Confucius : the Secular as Sacred* (Harper & Row 1972); Goldin, *Confucianism* 19-21.

[828] It is from the Great Learning, one of the Four Books of Confucianism. The original text is "because the ancients desired to make their brilliant virtue shine throughout the world, they first ordered their States; desiring to order their States, they first regulated their families; desiring to regulate their families, they first cultivated themselves; desiring to cultivate themselves, they first rectified their hearts; desiring to rectify their hearts, they first made their intentions sincere; desiring to make their intentions sincere, they first brought about knowledge. Bringing about knowledge lies in investigating things. After things are investigated, knowledge is brought about; after knowledge is brought about, one's intentions are sincere; after one's intentions are sincere, one's heart is rectified; after one's heart is rectified, one cultivates oneself; after one has cultivated oneself, one's family is regulated; after one's family is regulated, the State is ordered; after the State is ordered, the world is at peace". See Goldin, *Confucianism* 32; James Legge, *The Four Books: Confucian Analects, the Great Learning, the Doctrine of the Mean, and the Works of Mencius* (Paragon Book Reprint Corp. 1966) 310-313.

morality. Therefore, the ruler's behavior had a great influence on his subjects.[829] Under such a philosophy of governance, there was an order with respect to the relationship between people. The lord acts as a lord, the minister as a minister, the father as a father, and the son as a son.[830] It presented an orderly role for each individual in the society. The philosophy put an emphasis on the virtue of "filial piety" (respect for parents, Xiao).[831] Confucians advocated that filial piety was the first step of adherence to morality since it accommodated the step-by-step approach through regulating the family. Filial piety firstly meant moral behavior towards one's parents. It was further developed in the Canon of Filial Piety.[832] "The beginning of filial piety is serving one's parents; the middle is serving one's ruler; the end is establishing oneself." [833]

(2) Neo-Confucianism

After the Han dynasty, the status of Confucianism experienced declining periods, especially in the Tang dynasty (618-907).[834] The revival of Confucianism started since the Song dynasty (960-1279). It was called Neo-Confucianism, which created developments in relation to traditional thoughts. The main theory was that, in order to understand fully the true meaning of Confucian

[829] As the ruler is the example for his subjects in virtues, the people will examine the ruler's conduct and adjust their own accordingly. See Confucius, *The Analects of Confucius* (The Floating Press 2010) Book XIII-Tsze Lu VI. The Master said: "when a prince's personal conduct is correct, his government is effective without the issuing of orders. If his personal conduct is not correct, he may issue orders, but they will not be followed".

[830] See ibid Book XII-Yen Yuan XI. The Duke Ching, of Ch'i, asked Confucius about government. Confucius replied, "there is government, when the prince is prince, and the minister is minister; when the father is father, and the son is son."

[831] Chinese pin yin.

[832] Canon of Filial Piety is the Confucian classic about behavior towards the father, the brother, or the ruler. See Alan Kam-leung Chan and Sor-hoon Tan, *Filial Piety in Chinese Thought and History* (RoutledgeCurzon 2004);Norman Kutcher, *Mourning in Late Imperial China : Filial Piety and the State* (Cambridge University Press 1999).

[833] Ibid. It was abused by rulers in the imperial dynasties as an instrument to control people's minds to strictly follow orders.

[834] In the Tang dynasty, Daoism and Buddhism enjoyed more preferences by emperors. Daoism generally is a philosophical school of thought that emphasizes living in harmony with the Dao. Dao means the way, path, or principle. See Livia Kohn, *Introducing Daoism* (Journal of Buddhist Ethics Online Books 2009). Buddhism originated in India and was introduced in China in the Eastern Han dynasty (58-75 AD). It flourished in the Tang dynasty, which emphasized the imperishability of the soul, or spirit, and causes and effects. There were different branches of Buddhism, but, as commented by some authors, it had adapted to the existing philosophical thoughts in imperial China, and thus was able to become popular. See Yijie Tang, *Confucianism, Buddhism, Daoism, Christianity and Chinese Culture* (University of Peking 1991) 89-136; Jungnok Park, *How Buddhism Acquired a Soul on the Way to China* (Oxford Centre for Buddhist Studies Monographs, Equinox Publishing Ltd 2012) 5-37.

philosophies, the best way was to read the classics of Confucianism.[835] Accordingly, "investigate things", the initial step of the self-cultivation approach to a peaceful world, was reinterpreted as figuring out the concrete meaning of the concepts of the Confucian thoughts.[836]

6.4.3.2 The influence of Confucianism on the formation of China's state-oriented attitude

(1) Confucianism and governance in Traditional China

Confucianism was the sole authoritative school of thought that dominated the Han dynasty, and many authors have already touched upon the tentative reasons for this.[837] It is noticeable that Confucian thoughts actually accept a hierarchically-ordered society with a supreme ruler on the top. Although it emphasizes the ruler's own virtues and morality, with restrictions and qualifications, it advocates a highly organized central government system under the ruler. In addition, the self-cultivation approach to a better human being actually helps to maintain an orderly society with a hierarchy. All of these are beneficial for the emperor to be able to control and govern the state and the people. Moreover, it is also worth noting that Confucianism has absorbed many other schools of thought into it, and thereby it could accommodate the needs of the imperial ruler.[838]

Since the Song dynasty, Confucian thoughts were manipulated by the rulers to build a structured society with a strict hierarchy. People's minds were restricted as well, since they could only act according to the rituals written in the books. It helped to form the paternalistic way of the government until the end of imperial China. From this perspective, it was also considered to be a cultural factor that had cultivated obedient people in imperial China.[839]

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[835] Zhu Xi was the most active Confucian who advocated such a way of reading the classics. He was a leading Confucian scholar of the Neo-Confucianism in the Song dynasty.

[836] There was criticism of this way of understanding Confucianism in the Song dynasty as well. The most prominent was Lu Jiuyuan (1139-1193), who claimed that Li did not only exist in books. See Goldin, *Confucianism* 103-105.

[837] Bary and Mei, *Sources of Chinese Tradition* 264; Goldin, *Confucianism* 109-112.

[838] Ibid.

[839] Cezong Zhou, 'The Anti-Confucian Movement in Early Republican China' in Arthur F. Wright (ed), *The Confucian Persuasion* (The Confucian Persuasion, Stanford University Press 1960) 288-312.

(2) Confucianism in socialist China: rule of virtue

In socialist China, since the official announcement of the rule of law in the 1990s, Confucianism was considered to have revived and modernized accordingly.[840] Since 2004, an increasing number of Confucius Institutes have been established in 120 countries and regions around the world.[841] However, such modernization of Confucianism still has a state-oriented feature.

A main characteristic of China's socialist rule of law is the combination of rule of law with rule of virtue.[842] Confucianism is a main source to support the government's idea of the rule of virtue. The rule of virtue aims to guide government officials by putting people first and implementing a people-based administration. By emphasizing government officials' morality, it also aims at creating benevolent governance.[843] It seems to be a good combination with the rule of law to limit the government's power. Nevertheless, it is also regarded as the government's attempt to shape Confucianism to its goals. In an increasingly pluralistic society in current China, the revival of Confucianism actually represents the government's aim of stabilizing the current social order. The core thoughts of Confucianism, such as humanity, filial piety, and self-cultivation, actually match the government's purpose of establishing a "harmonious society" in China.[844] Therefore, the revival of Confucianism has been promoted by the government.

(3) Confucianism and Chinese culture

Max Weber (1968) once attributed the failure of capitalism in China to Confucianism.[845] According to Weber, the tradition of reading classics in Confucianism since the Song dynasty impeded people's creativity and curiosity for new things. In contrast, the puritan spirit of Protestants, the emphasis on asceticism and a moral way of pursuing profits had catalyzed people's eagerness for the accumulation of wealth in capitalist countries.[846] Similar to the analysis in the

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[840] Anja Lahtinen, 'China's Soft Power: Challenges of Confucianism and Confucius Institutes' (2015) 14 Journal of Comparative Asian Development Shufang Wu, '"Modernizing" Confucianism in China: A Repackaging of Institutionalization to Consolidate Party Leadership' (2015) 39 Asian Perspective 301.
[841] Lahtinen, 'China's Soft Power: Challenges of Confucianism and Confucius Institutes' 211.
[842] Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 60-61.
[843] Kelvin C. K. Cheung, 'Appropriating Confucianism: Soft Power, Primordial Sentiment, and Authoritarianism' in Joseph Tse-Hei Lee, Lida C. Nedilsky and Siu-Keung Cheung (eds), *China's Rise to Power, Conceptions of State Governance* (China's Rise to Power, Conceptions of State Governance, Palgrave Macmillan 2012) 41-42.
[844] Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 61.
[845] Max Weber and Hans H. Gerth, *The Religion of China : Confucianism and Taoism* (Free Press ; Collier-Macmillan 1968).
[846] Ibid.

previous part, theories are subject to the limitations of their times. Some authors have challenged Weber's remarks that it is difficult to establish a direct causal link between the Protestant spirit and the origin of capitalism, and thus the same logic is relevant for the relationship between Confucianism and China's development.[847] Therefore, it is more rational to review the influence of Confucianism from the angle of how Confucianism was adopted by the rulers in imperial China to control the state and people.

As commented by Shuming Liang (1999), a modern Confucian, Confucians always tried to adapt to the environment and the world rather than mastering or changing it.[848] Therefore, the influence of Confucianism on Chinese culture was that it contributed to the tradition of intuitionism, which dealt more with mental and spiritual issues. Whereas the Western culture attempted to address people's material needs first. Consequently, Western culture was more realistic. On the contrary, Confucians advocate on harmony and self-cultivation and this interacted with the Chinese attitude of adaption and adjustment, thereby leading to the possibility for Chinese people to live in an orderly society with hierarchy. This was not due to outside enforcement but to the willingness of the individual.[849] Chinese philosophies, especially Confucianism, took active and human attitudes towards social reality, but they failed to adjust to the political reality in traditional China. Therefore, most of those ideal philosophical thoughts were manipulated by the rulers in each dynasty as instruments for their rule. In addition, although these philosophies emphasized humanism, they were seldom concerned with the basic rights of individuals, compared to the Western counterpart, and thus this hindered the development of personal character. Hence, it was difficult for such a traditional Chinese philosophy to develop into the Western model considering the relationship between the state and people.[850]

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[847] It is argued that Confucianism has played an important role in the economic development of other Asian countries, such as Japan, Singapore, and South Korea, etc. Huang, *Capitalism and the 21st Century (Zi Ben Zhu Yi Yu Er Shi Yi Shi Ji)*; Chen H. Chung, Jon M. Shepard and Marc J. Dollinger, 'Max Weber Revisited: Some Lessons from East Asian Capitalistic Development' (1989) 6 Asia Pacific Journal of Management 307.

[848] Shuming Liang, *The Culture and Pholosophy of the East and the West* (Shang Wu Press 1999) 205 (in Chinese); Guy S. Alitto, *The Last Confucian : Liang Shu-ming and the Chinese Dilemma of Modernity* (University of California Press 1979).

[849] Ibid.

[850] Ibid.

6.4.3.3 Discussion

As analyzed at the beginning, it is not rational to attribute the paternalistic attitude of the government in imperial China to the sole influence of Confucianism. The philosophies have evolved over the entire history of China, so they have also deviated from the original ones. It is difficult to conclude that those philosophies were what was intended by Confucius. Even if they were, it is never easy to judge them, since, as philosophical thoughts, they are neutral and subjective. Only when they were employed, they developed more functions and power in relation to the formation of the traditional relationship between the state and people and the instrumentalist use of law.

6.4.4 Conclusion

The previous analysis has depicted factors that contribute to China's state-oriented attitude towards taxation and the instrumentalist treatment of law. It is commented by some authors that China lacks a free market culture and the rule of law if evaluated from the Western standard.[851] However, cultural factors have their own limitations. They should not be regarded as obstacles to carrying out reforms.

Although China's total economy is huge and ranks rather high in the world, considering the sheer size of China, it can hardly be concluded that China has developed into a high-income country, not to mention the large regional disparity, and the gap between the wealthy and the poor.[852] As the Chinese government has announced, China is in a crucial transitional period, from a middle-income country to a high-income country.[853] Despite the fact that China is reforming the

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[851] Randall Peerenboom, 'Assessing the Implementatino of Law in China: What's the Standard?' in Mattias Burel Marina Svennson (ed), *Making Law Work* (Making Law Work, Cornell University Press 2011).

[852] It is not the aim of the research to debate on China's status as a developing country or not, since the criteria are not universal and are in flux. It is clear from economic indexes that China is not yet a high-income country. This is based on statistics from the World Bank. It classifies countries into different income groups, i.e. high income countries, low income countries, lower middle income countries, and middle income countries. China belongs to the category of middle income countries. See data from the World Bank <http://data.worldbank.org/income-level/MIC>, accessed 25 April 2016.

[853] On the 22nd Asia-Pacific Economic Cooperation (APEC) Economic Leaders' Meeting (10th November 2014), President Jinping Xi of China said that China is able to get through the "middle-income gap". See <http://www.fmprc.gov.cn/mfa_eng/topics_665678/ytjhzzdrsrcldrfzshyjxghd/t1209907.shtml>. In 2007, the World Bank first raised the term "middle-income trap" in the report An East Asian Renaissance: Ideals for Economic Growth. It describes the phenomenon that rapidly growing economies get stagnated at middle-income levels and fail to develop into the ranks of high-income countries, such as several Latin American and East Asian economies. See Indermit Gill and Homi Kharas, *An East Asian Renaissance, Ideas for Economic Growth* (The World Bank 2007).

state-oriented model of development and the instrumentalist attitudes towards law, especially tax incentives, it is unrealistic to expect that it can finish the transformation in the short term. On the other hand, the direction of the transformation in the legal area is not likely to be the same as the Western Liberal Democratic one.[854]

Nevertheless, it is not argued that China can abuse all the above-mentioned factors as justifications to defend any incompatibility of its measures with the WTO agreements. Virtually, both the instrumentalism attitude towards tax incentives and the state-oriented style of treating the relationship between the government and the market can cause problems.[855] For instance, the instrumentalist approach to tax incentives can increase uncertainty for taxpayers, since those incentives can easily be changed or removed. Moreover, such unjustified discrimination harms the principle of equality.[856] With the further development of the market economy in China, more certain and transparent legal systems are necessary. Since the Chinese government admits that "a market economy is a rule of law economy",[857] thus, regardless of the differences between China and the West towards the treatment of tax incentives and the rule of law, under the framework of the market economy, something in common can be pursued and achieved.

6.5 Matrix of the comparison between China and the West towards the treatment of tax incentives

	The West	**China**
Different attitudes towards tax incentives	1. Taxation serves public finance 2. instrumentality controlled by the rule of law	1. State-oriented attitude towards taxation 2. Lack of internal legal control over the granting of tax incentives
The relationship between the	Market-oriented, the government intervenes only when necessary	State-oriented, the market operates under the state's macro control

[854] Ibid.

[855] Tamanaha, Talsma and Mierlo, *The Perils of Pervasive Legal Instrumentalism*; Brian Z. Tamanaha, 'The Tension between Legal Instrumentalism and the Rule of Law' (2005) 33 Syracuse Journal of International Law and Commerce 131.

[856] Gribnau, 'Legislative Instrumentalism vs. Legal Principles in Tax' 99-100. Tamanaha, Talsma and Mierlo, *The Perils of Pervasive Legal Instrumentalism*.

[857] In 2014, the Fourth Plenary Session of the Eighteenth Central Committee of the CCP promulgated the CCP Central Committee Decision concerning Some Major Questions in Comprehensively Promoting Governing the Country According to Law. The Decision announced the establishment of the socialist rule of law with Chinese characteristics and build a country under the "socialist rule of law".

market and the government		
The market (16th century to 21st century)	The WTO is the outcome of capitalism Origin and evolution of the market-oriented system: 1. Early 16th century **Adam Smith:** no government intervention into the economy, free competition 2. Late 18th century to 19th century **David Ricardo:** no government intervention into the economy; self-regulating market; comparative advantage for international trade 3. After the Second World War: **John Maynard Keynes:** governmental interference into the market 4. 1970s **Friedrich Hayek** Market capitalism, less government interference into the market 5. 21st century The current WTO system **Mixed economy:** both market force and government intervention work, but the market plays a decisive role	**1. Socialist China** **(1) 1949-1978** Planned economy No free market **(2) 1987-present** Market economy under the state's macro control SOEs have main market access in key industries Tax preferences for SOEs **2. Traditional China** (16th century to 1949) It has not experienced the period of capitalist development It was an agricultural country **Pro-agriculture and anti-commerce policy**
The state (16th century to 21st century)	The formation of the capitalist state: 1. Early 16th century **Machiavelli:** objected to religious beliefs in politics; a powerful leader or state for people 2. 17th century **Hobbes:** Leviathan, a well-functioning state	**1. Socialist China** **(1) 1949-1978** Before the Reform and Opening Planned economy Socialist ideology State-oriented taxation **(2) 1978-present** Tax preferences for SOEs **2. Traditional China** (16th century to 1949) Ming and Qing dynasties Political centralization

	Locke: the state is the product of social contracts, so the government should guarantee citizens' basic rights 3. 21st century **Modern state:** protect individual rights and serve for the public good	The state was the emperor's state, which served the emperor's rule **Taxation:** no separation between the emperor's personal income/expenditure and the state's income/expenditure
Attitude towards law	The rule of law is associated with the development of capitalism Respect for legal order and the rule of law **Rule of law:** thin and thick theories Aim: to restrain the arbitrary use of state power and to protect individuals' property rights **Liberal Democratic rule of law**: free market capitalism, multiparty democracy and a liberal interpretation of human rights	The instrumentalist use of law **1. Socialist China** **(1) 1949-1978: Marxism** Taxation and law, as a part of the superstructure, was subordinate to the economy **(2) 1978-present: socialist rule of law with Chinese characteristics** No legal control over tax incentives **2. Traditional China** Rule by rituals and rule by law Law was an instrument to serve the interests of the emperor and the state
The culture	**Max Weber:** Protestantism Be rational and take risks to seek profits **Capitalist spirit:** Respect for the market, fair competition, and cooperation State: protect individual rights and serve for the public good Interfere in the market when necessary Respect for legal order and the rule of law Rule of law: Liberal Democratic rule of law **Philosophies:** Heading forward and realistic	Paternalistic government State-oriented tradition **Confucianism:** Humanity Self-cultivation: virtue and ritual Government: correct people's mind, guide them to morality Social hierarchy: based on filial piety Advocated a highly organized government under the ruler **Neo-Confucianism:** reading classics Used by rulers to cultivate obedient people **Confucianism in socialist China:** Rule of virtue Harmonious society State-oriented **Max Weber:** reading classics impeded people's creativity and curiosity for new things

		Philosophies: Adaption and adjustment to the environment and the world Mentality and spirits

6.6 The common platform: possibilities to alleviate tensions

China has undertaken a different path towards its market economy and the rule of law. Once the differences exist, it is not difficult to predict that the tensions with the WTO will continue. However, despite all those differences, it is a fact that China is a Member of the WTO. Every Member of this organization is under an obligation to follow its rules. Therefore, it is important for China to seek common ground with the WTO.

After the analysis of these tensions and their origins, the question arises with regard to the possibility to alleviate them. Actually, the problems related to these tax incentives are not only specific for China, but they are also relevant for other Members of the WTO. For example, many countries have SOEs to which they provide tax incentives, and therefore this is not only a problem for the Chinese government. The specificity of the measures lies in the fact that the Chinese socialist system grants a priority status to SOEs. It involves not only a legal reform but also the liberalization of the market. Furthermore, it triggers a discussion on how important liberalization and fairness is to the Chinese market. The government can choose how to treat them, either maintaining the preferential treatment or treating them equal to other enterprises. With regard to the regional tax incentives and tax incentives for high-tech enterprises and other enterprises, it is necessary to consider the actual circumstances in China, but it is still possible to regulate the granting of tax incentives through an internal legal control system. It is not the intention to find an "all or nothing" approach to deal with the problem but to find a solution that both China and the WTO can accept.

6.6.1 For China

6.6.1.1 Fair competition in the market

Although China's socialist market economy system is different from the common market economy system among the other Members of the WTO, it is possible to look for common objectives that can serve as a common platform to alleviate tensions. The creation of fair competition in the international market is not only the main objective of the WTO's subsidy regime, but it should also be the purpose of the operation of the market under China's economic framework. For China, there is great motivation for it to further integrate into the world economy and benefit

from a better international trade environment.[858] In order to maintain the economic growth, China has to explore more opportunities in both the domestic and international market. Considering the slowing down of the current economic growth,[859] it is more urgent to pursue more opportunities in the international market, which requires mechanisms to ensure fair competition in China's domestic market and China's fair participation in the international market.[860] The relationship between the government and the market is a dynamic process. Although the market operates under the state's macro control, it does not deny the market's role in the allocation of resources. Therefore, under China's market system, the creation of fair competition should also be the objective in order to increase efficiency.[861] In fact, China seems to realize the importance of strengthening the market's role in order to keep its economic growth. In 2013, it officially announced that the central government would strengthen its governance in relation to tax incentives to promote equality in tax burdens and fair competition.[862] Thus, based on the objective of creating fair competition in the market, it is possible to regulate the granting of tax incentives in China.

As analyzed in the internal benchmark in Chapter 3, the principle of equality is also applicable in China. The common appreciation for equality can function as the basis for the creation of the common platform. The trend of the legal reform in relation to Chinese tax incentives has already provided evidence that fair treatment for taxpayers is gaining more attention. Therefore, under the common object and purpose of pursuing fair competition in the market, it is possible to build a further platform for those parties to reduce trade disputes.

6.6.1.2 Internal legal control over tax incentives

China's instrumentalist use of tax incentives causes adverse effects, and therefore the introduction of an internal legal control is an effective way to tackle the problems. The

[858] OECD, *China's Emergence as a Market Economy: Achievements and Challenges* (OECD contribution to the China Development Forum 20-21 March 2011), http://www.oecd.org/china/47408845.pdf.
[859] China's GDP growth was 6.9% in 2015, which was the lowest in the past 25 years. Justin MacCurry, China Economy Grows at Slowest Pace in 25 years, Latest GDP Figures Show, *the Guardian*, 19 January 2016,<http://www.theguardian.com/world/2016/jan/19/china-economy-grows-at-slowest-pace-in-25-years-latest-gdp-figures-show>, accessed 2 May 2016.
[860] Since the beginning of 2015, China's economy faced more challenges, which made it difficult to maintain the high-speed growth. The government is planning to carry out further tax reforms to stimulate economic growth.
[861] Qian and Wu, 'China's Transition to A Market Economy' 48-61.
[862] The Decision of the Central Committee of the Chinese Communist Party (CCP) on Some Major Issues Concerning Comprehensively Deepening the Reform (the 2013 Decision). For the English version, see <http://english.cntv.cn/special/18thcpcsession/homepage/index.shtml>, accessed 23 November 2015.

instrumentalist treatment of tax incentives increases uncertainty for taxpayers, since those incentives can easily be changed or removed.[863] Moreover, discrimination caused by tax incentives harms the equality between taxpayers.[864]

Even as instruments, tax incentives are not good instruments to achieve governmental goals while fulfilling the criteria of transparency, economy, efficiency, and effectiveness.[865] An essential element to evaluate the instrument is the level to which it achieves these goals. Nevertheless, in the context of Chinese tax incentives, it is difficult to evaluate according to such a standard. The first problem is that the policy goals of certain tax incentives, such as tax incentives for decreasing regional disparity, are too broad or ambiguous. Tax incentives should serve specific objectives, thereby providing policy guidance; otherwise, they are too broad to promote certain activities. However, most tax incentives in China have broad and multiple objectives, which makes it difficult to carry out an assessment afterwards, due to the ambiguity of the objectives in the beginning.[866] This research focuses on tax incentives related to business investments in international trade. Such tax incentives should have clear and specific purposes in principle. Nevertheless, broad objectives cause conflicts and overlaps. For example, in relation to regional tax incentives for instance, the balance of regional disparity requires that the less developed Western and Central regions in China should enjoy more tax incentives, however, the policy to attract FDI determines that enterprises in eastern coastal regions actually enjoy more benefits from tax incentives.[867] Another problem is the difficulty of evaluating the effectiveness of those tax incentives. In order to know the result of tax incentives, a cost-benefit analysis is necessary. However, in China, there is a lack of empirical

[863] Tamanaha, Talsma and Mierlo, *The Perils of Pervasive Legal Instrumentalism* 65-68; Tamanaha, 'The Tension between Legal Instrumentalism and the Rule of Law' 131.
[864] Gribnau, 'Legislative Instrumentalism vs. Legal Principles in Tax' 99-100; ibid.
[865] Li, *Legal Analysis of Tax Expenditure System* 129-132 (in Chinese); Zee, Stotsky and Ley, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries'; Yaobin Shi, Establishing a Tax Expenditure Administrative System That Achieves a Sound Fiscal System in China, Shandong Sheng China International Forum on Tax Expenditures Weifang and others, *Tax Expenditures--Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies* (World Bank 2004) 177-179.
[866] Guoqiang Ma, 'China's Current Tax Expenditure System: Issues and Policy Options' in Hana Polackova Brixi International Forum on Tax Expenditures , Christian Valenduc, Zhicheng Li Swift (ed), *Tax Expenditures--Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies* (Tax Expenditures--Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies, World Bank 2004) 196-198.
[867] Ibid 198.

analysis or evaluations of those incentives.[868] The incentives are based on the government's subjective anticipation of benefits, but without a systematic ex-ante assessment, not to mention an ex-post evaluation.[869] Moreover, the granting of tax incentives has "path dependence", which lacks a full assessment but only extends measures that seem to have been effective in the past. This has increased the difficulty to make a judgment on the results of those incentives.[870] With the further development of the market economy in China, a more certain and transparent legal system is necessary.

In fact, since the promulgation of the Reform and Opening Policy, China has already made great achievements with respect to the establishment of legal systems. The tension arises in relation to which standard should be used to evaluate the function of the law.[871] Although China has its own approach towards the establishment of the rule of law, it can still meet the criteria according to the thin rule of law. Consequently, bringing the granting of tax incentives into a more legalized system would not only achieve the goal of establishing the socialist rule of law for China, but it would also improve the compatibility of Chinese tax incentives with the WTO's subsidy rules.[872]

6.6.1.3 The cultural issues

Western countries not only have a mature market economy and well-functioning legal system, but they also have the associated legal culture. It is a kind of awareness among people that they are willing to respect and follow the law in order to maintain fair competition in the market. According to the Western legal theories, law just reflects social values but does not create values.[873] Social values are not granted by the government or the authority, but they are the natural

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[868] International Forum on Tax Expenditures Weifang and others, *Tax Expenditures--Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies* 198.
[869] Li, *Legal Analysis of Tax Expenditure System* 131.
[870] Wei Xiong, 'Normative Research on the Cleaning up of Tax Incentives from the Perspective of the Rule of Law' (2014) 6 China Legal Science (in Chinese).
[871] Peerenboom, 'Assessing the Implementatino of Law in China: What's the Standard?'.
[872] Xiong, 'Normative Research on the Cleaning up of Tax Incentives from the Perspective of the Rule of Law'154 (in Chinese); Jianwen Liu, 'Positionning and Shaping Finance and Tax Law from the Perspective of Economic Transformation' (2014) 4 Legal Forum (in Chinese); Jianwen Liu, 'The Legality Principle of Tax Law: a Modern Approach to the Legality of Power' (2014) 4 The Jurist 19 (in Chinese); Jianwen Liu, 'On the Ways to Crack China's Fiscal and Tax Law Plight: Focusing on the Problems and Breakthroughs' (2013) 35 Modern Law Science 65 (in Chinese).
[873] Lawrence Rosen, *Law as Culture : An Invitation* (Princeton University Press 2006); Randall Lesaffer and Jan Arriens, *European Legal History : A Cultural and Political Perspective* (Cambridge University Press 2009).

outcome of the society. In the evolution of the relationship between the market and the government, this kind of legal consciousness has already become an essential part of the culture itself.

In contrast, such legal awareness is comparatively lacking in China, but it is also increasing now.[874] From the comparison above, it is obvious that the Chinese society has its own attitudes and rationale towards the government and the market. Nevertheless, cultural factors are always in flux, as it has already been emphasized before. With the further development, modernization and urbanization in China, legal awareness is increasing among individuals, especially in urban regions.[875] Therefore, the dynamics demonstrate that at least there is an increasing space for Chinese people to accept the common rules that are shared by the international community. Cultural issues should be taken into account when looking for the common platform, but it should not become an obstacle or excuse to conduct further reforms.

6.6.2 For the WTO

The search for a common platform is not just one-dimensional. Except for China's transformation, the WTO can also take into account the origin of the tensions for its own sake. As analyzed before, the market economy in the WTO system is in such a dynamic process that the associated rule of law is changing as well. In addition, the WTO is such a large international organization that not every WTO Member has a typical market economy and rule of law system, especially the Liberal Democratic rule of law. Initially, the establishment of the WTO was the outcome of the development of capitalism; however, with more and more Members joining the organization, it has also become diversified. Thus, it is possible for the WTO to adapt its rules to the changing circumstances. The tensions between China just provide an opportunity for the WTO to review its systems. Moreover, EU State aid can shed light on the improvement of the subsidy rules in the WTO with regard to the design of the legal control procedures and more detailed consideration for the compatibility issues.

6.7 Conclusion

This chapter focused on the analysis of the testing results. The testing results show that regional tax incentives, tax incentives for SOEs, and tax incentives for high-tech enterprises, such as the software industry, IC industry, and energy-saving service enterprises in China are likely to be the

[874] Peerenboom, 'Fly High the Banner of Socialist Rule of Law with Chinese Characteristics!' 61-62.
[875] Lianjiang Li, 'Rights Conciousness and Rules Consciousness in Contemporary China' (2010) The China Journal 47.

root of conflicts with subsidy rules in the WTO. Actually, they reflect deeper tensions between Chinese tax incentives and the Western treatment of tax incentives. China has a state-oriented attitude towards tax incentives, and there is a lack of internal legal control over the granting of tax incentives in China. In contrast, under the Western framework, tax incentives are a result of the government's interference into the market, and therefore they should be controlled legally. The main reason behind the tensions is that the relationship between the government and the market in China is different from its counterpart in the West. The context in which WTO law and EU law have developed is the operation of a market economy. In the relationship between the government and the market, the market still plays a decisive role in the allocation of resources. In order to guarantee the functioning of the market, governmental intervention in the form of tax incentives should be regulated. However, China has a different economic system, a socialist market economy. The state has more power over the market. Taxation in China serves for the role of the state. The state plays an essential role in the allocation of public goods or social products. The government does not consider the granting of tax incentives as an intervention into the market but as a way of having macro control over the economy.

Additionally, China's attitude towards the rule of law has resulted in a lack of internal legal control over the granting of tax incentives. The WTO's system and the EU State aid regime are based on the Western rule of law theories. In order to guarantee fair competition in the market, governmental actions should be controlled by the law. However, China takes an instrumentalist attitude towards the use of tax incentives. The rule of law in China is different from the Western Liberal Democratic rule of law. China has conducted legal reforms in many regimes, but the legal format is still different from the basic one under the Western system. Therefore, the granting of tax incentives in China lacks internal legal control in terms of the Western legal standard.

This chapter also analyzes the origins behind the tensions by separately depicting the Western path towards its treatment of tax incentives as subsidies and China's path and its attitude towards tax incentives. With regard to the WTO's subsidy rules and EU State aid law, the starting point of analyzing the market-oriented system is to acknowledge that they are the outcome of the capitalist development. The relationship between the market and the government has experienced changes from the early 16th century to the present time, which could be reflected by different economic schools of thought in different periods. However, from Adam Smith to Friedrich Hayek, the market

still plays a decisive role in the allocation of resources, and the government intervenes when necessary. The modern state is also an outcome of capitalist developments, since it requires a powerful government to protect individual rights and to serve the public good. The economic thoughts contribute to the understanding of the development of the Western market-oriented system. With respect to the legal regulation of tax incentives in the West, the WTO and the EU have a system based on the rule of law. Regardless of the diverse theories on the rule of law, associated with the development of the market economy, the basic objective of the rule of law is to prevent the arbitrary use of state power and to protect the market order. This also explains why subsidy rules in the WTO and State aid law in the EU, as legal regulations, restrict the use of tax incentives provided by governments. Furthermore, as advocated by Max Weber, for instance, there is even a capitalist spirit or Western culture that contributes to the development of the market-oriented system and the respect for the rule of law. The philosophies, including being realistic, respect for individual rights, respect for fair competition and cooperation, and the like help to understand the issue deeper.

Similarly, China's state-oriented attitude towards tax incentives has historical roots. Considering China's long history, this chapter limited the discussion to the period that is comparable to the capitalist development in the West by dividing the time into socialist and traditional China. In the time of socialist China, from the establishment of the PRC in 1949 to the Reform and Opening in 1978, China had a planned economy and the socialist ideology. There was no free market and the state had absolute control over taxation. After the Reform and Opening, the state still has macro control over the whole economy, includes tax preferences for SOEs. In the time of traditional China, China did not experience the period of capitalist development that was comparable in the West. It was an agricultural country that always adhered to the policy of pro-agriculture and anti-commerce, and therefore there was no free market from the Western perspective. As to the state's function, taxation serves the state's allocation of resources in socialist China. In traditional China, the state was emperor's state, which served the emperor's rule. There was no separation between the emperor's personal income or expenditure and the state's income or expenditure.

The lack of an internal legal control over the granting of tax incentives in China can also find its origin in socialist and traditional China. In socialist China, before the Reform and Opening,

influenced by Marxism, taxation and law, as part of the superstructure, were subordinate to the economy. Thus, they were treated only as instruments to achieve economic goals. After the Reform and Opening, China attempted to establish a socialist rule of law system, which promoted intensive legal reforms in various areas. However, there is still a lack of legal control over the granting of tax incentives. In traditional China, law was an instrument to serve the interests of the emperor, which was also instrumental.

A cultural influence for such a state-oriented style that could not be ignored is Confucianism. Confucianism experienced an evolution and there were limitations on explaining the relationship between Confucianism and the origin of the state-oriented style. However, they contribute to the understanding of this style. By advocating humanity and self-cultivation through virtue and ritual, Confucianism actually supports a highly organized government under the ruler. In socialist China, the modernization of Confucianism is also driven by the state. The government's support of the Confucian rule of virtue is actually an attempt to maintain a harmonious social order according to the government's cultural goal. In addition, the philosophies underline adaption and adjustment to the environment and the world rather than going against them. When understanding these philosophies, it is easier to understand China's state-oriented attitude towards tax incentives.

Nevertheless, it is possible to find a common platform for China and the West to alleviate tensions. The market rules are also applicable in China's market. The creation of fair competition in the market can serve as the common objective between China and the West. Moreover, China's instrumentalist attitude towards the granting of tax incentives has adverse effects. The legal control of tax incentives is in line with China's reform towards the rule of law. Therefore, the common objectives that both China and the West intend to create a level playing field in the international market can serve as the common ground to alleviate tensions.

Chapter 7 Recommendations for Chinese Tax Incentives and the Future for the WTO's Subsidy Rules

7.1 Introduction

As analyzed in previous chapters, there are tensions between China's treatment of tax incentives and the requirements of the WTO. These constitute the main reasons for trade disputes against China under the WTO's subsidy regime, and the disputes will probably continue if the tensions continue to exist. However, there is space for each party to find a common platform to alleviate tensions, considering the creation of a level playing field for competition.

This chapter has the purpose of answering the research questions. Firstly, it makes recommendations for China in relation to granting tax incentives to adapt to a proper position in the international trade and investment domain. In addition, it provides insight into the WTO and its subsidy regime with respect to the role of taxation. Based on a previous analysis, the EU State aid law acts as a reference for both China and the WTO for the improvement of the legal framework for the control of tax subsidies in certain aspects. In order to make recommendations for the Chinese tax incentives, the chapter returns to the benchmarks first, which serves as the starting point and basis for recommendations. The recommendations for the WTO also takes these benchmarks as the basis.

7.2 Recommendations for Chinese tax incentives

7.2.1 Basis for recommendations

7.2.1.1 Fair competition in the market

This research has established an external benchmark and an internal benchmark respectively in Chapter 3 and Chapter 4. The external benchmark is derived from the common objectives and purposes of the WTO's subsidy system and the EU State aid regime. The creation of a level playing field in the supranational market follows from the requirement of efficiency and equity in the market. The internal benchmark justifies that there should be a level playing field for competition under China's socialist market economy. Furthermore, the internal benchmark shares the same essence of the external benchmark for the pursuance of fair competition in the market. Although the starting points of establishing a fair market in the West differ from the counterpart in China, the benchmarks actually reflect that, in order to let the market function well for the allocation of resources, it is necessary to ensure the fundamental conditions for its operation.

With respect to Chinese tax incentives, it is important to bring them into line with fair competition. The testing results demonstrate that certain specific tax incentives are likely to constitute actionable subsidies under the WTO's subsidy regime. They imply that they could harm the level playing field guaranteed by the WTO, thus causing adverse effects to other Members.[876] The testing results also reveal deeper tensions. In fact, the easiest recommendation for China is to remove all the incompatible tax incentives to meet the criteria of the WTO. Nevertheless, due to China's state-oriented attitude towards the use of tax incentives and the lack of internal legal control over granting them, the tensions will continue. The reason is that the government's arbitrary granting of tax incentives lacks legal assessment, which is guided by the objective of fair competition in the market. Such arbitrary granting of tax incentives will eventually conflict with WTO's legal requirements and assessment. The direct result is that China will consistently face trade disputes with regard to its tax incentives. If China hopes to benefit more from the world economy, it is necessary to adjust its attitude towards tax incentives in line with the benchmarks.

Therefore, it has to be emphasized that the recommendations of this research in respect of Chinese tax incentives is that they should contribute to the aim of guaranteeing a level playing field in China's market, which also would enable China to participate in the fair competition in the international market.

7.2.1.2 Rule of law over tax incentives

To establish fair competition in both China's domestic market and to meet the requirement of fair competition in the international market, it is important to introduce the rule of law as a guarantee. This is the original theory on which the WTO's subsidy rules and EU State aid law have been based, as discussed in previous chapters. To alleviate the tension, i.e. a lack of internal legal control over Chinese tax incentives versus the WTO's subsidy regime established according to the rule of law, the direct solution should be the introduction of a legal control regime for Chinese tax incentives.

[876] It has to be emphasized that the testing results are the outcome of the research, based on the research questions and methodologies. It just shows that certain tax incentives may potentially constitute actionable subsidies if they are identified as such according to the testing steps of the ASCM. However, it does not mean that in reality they have caused trade disputes.

The previous chapters demonstrate that China has accomplished impressive achievements with regard to the legalization of taxation, especially after China's accession to the WTO.[877] As discussed in Chapter 6, despite the fact that China does not have a Western Liberal Democratic rule of law system, it does not mean that it is not possible to establish an internal legal control system in the field of tax incentives.[878] The introduction of an internal legal control system for tax incentives is essential to promote economic growth in China. As has been justified by some authors, a positive correlation exists between sustainable economic growth and the establishment of the rule of law. [879] China has identified economic growth as its major and long-term goal.[880] If China intends to maintain its economic growth, the alleviation of tensions with the WTO rules will definitely help to reduce trade disputes. Moreover, it contributes to China's further integration into the world economy by embracing more rules that are commonly accepted by the international market.[881] Therefore, the introduction of a legal control regime over Chinese tax incentives serves well for the creation of fair competition in the market, which eventually contributes to the promotion of efficiency under a market economy system.

The further focus should be on the type of legal control and the approach to establish such a legal regime. According to theories on the rule of law, an essential element of the rule of law system is to include procedural and institutional elements.[882] These elements embody the role of the legislator, the administration, and the court.[883] As pointed out by some authors, performing governmental duties according to the law first requires that the government makes decisions based

[877] See also Xiaobing Li and Qiang Fang, *Modern Chinese Legal Reform: New Perspectives* (The University Press of Kentucky 2013) 151-170.
[878] Chenguang Wang, *China's Journey toward the Rule of Law: Legal Reform, 1978-2008*, vol 1 (Brill 2010) 50.
[879] Kenneth W. Dam, 'The Law-growth Nexus the Rule of Law and Economic Development' (2006) 233-323; Peerenboom, *China's Long March Toward Rule of Law* 450-498; Li and Fang, *Modern Chinese Legal Reform: New Perspectives*.
[880] The primary goal of China's 13th Five Year Plan (2016-2020) is to maintain the economic growth at a mid to high speed. See Keqiang Li, Premier of the State Council, Report on the Work of the Government, delivered at the Fourth Session of the 12th National People's Congress of the PRC on 5 March 2016. For English version, see China Daily News 18 March 2016, http://language.chinadaily.com.cn/2016-03/18/content_23944369.htm (accessed 28 May 2016).
[881] As commented by some authors, the external obligations from the WTO would turn into internal motives for China to reform its legal systems. See Wang, *China's Journey toward the Rule of Law: Legal Reform, 1978-2008* 114-115.
[882] James Fleming, *Getting to the Rule of Law* (NYU Press 2011) 12-14.
[883] Ibid.

on statutory procedures.[884] The procedural elements could become the starting points when considering establishing a legal control over tax incentives in China. It has to be emphasized that recommendations in this chapter have been based on qualitative economic arguments rather than on quantitative economic arguments, which is also true for the economic analysis in Chapter 2. Thus, there is space for more quantitative economic research on testing of whether recommendations made in this chapter can contribute effectively to the creation of fair competition with regard to the granting of? tax incentives in China. However, this chapter focuses on recommendations that can sufficiently answer the research questions, which provides a starting point for China to adjust the treatment of tax incentives in order to better integrate into the world economy.

7.2.2 Recommendations at a macro level: introduction of an internal legal control over tax incentives

7.2.2.1 Reference from the tax expenditure system

(1) Overview on the tax expenditure system

A commonly adopted legal control method for tax incentives could be the introduction of a tax expenditure system, the concept of which was firstly developed by Stanley Surrey (1970) in the US, but it was widely accepted across various countries.[885] As analyzed in section 2.3.3 of Chapter 2, the most obvious feature of the notion is a deviation from a tax system benchmark.[886] The benchmark normally includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations, etc.[887]

Such a tax expenditure system is an internal legal control mechanism since it combines legal procedures on the control of tax incentives from the perspectives of legislation, administration, and evaluation. Firstly, it subjects tax incentives to a budgetary process, which entails a necessary legal assessment and authorization. Even though some countries do not include tax expenditures in the budget processes, they still have a separate evaluation process for tax expenditures.[888]Many

[884] Wang, *China's Journey toward the Rule of Law: Legal Reform, 1978-2008* 38.
[885] Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures'.
[886] Ibid 16.
[887] Li, Brizi and Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices' 3.
[888] OECD, *Tax Expenditures in OECD Countries* 60-63.

countries have established a tax expenditure system that brings tax incentives into the budgetary process. [889] Tax expenditures in different countries have different forms; some are in the form of an annex to the budget and some are independent documents.[890] This is a higher stage for the administration of tax incentives in a legalized way.[891] The purpose, costs and benefits, and effects for the granting of tax incentives are assessed by the legislative authorities at an initial stage, so that it forms a preliminary ex-ante assessment. In addition, most of those countries file tax expenditure reports regularly in order to provide transparent empirical information on their tax expenditures. [892] As a result, the reports could act as an ex-post assessment for the evaluation of implemented tax incentives. Thus, it is simple and efficient for tax authorities to administer and supervise the enforcement of those incentives. Moreover, it increases transparency in relation to the allocation of public revenue.[893] Most countries consider it as a legal obligation and publish it annually. In general, the system forms a procedural guarantee for the implementation of the law on tax incentives. In such a system, governments or tax authorities, as the subjects for the implementation, are also accountable. It therefore creates a regulation of the government's arbitrary power of granting tax incentives and increases the government's accountability. For instance, in the US, there is an independent institution that regularly evaluates tax expenditures.[894] Furthermore, as a part of the budget, taxpayers have the right to know them and the right to seek remedies.[895] In summary, the purpose of the establishment of a tax expenditure system is to control

[889] Many Western countries have established a tax expenditure system, such as the US, Canada, Australia, the Netherlands, Belgium, and Germany. See ibid 69-132.

[890] Some countries include tax expenditure reports as an annex to the budget, such as Austria, Belgium, France, Germany, and the Netherlands; some countries have separate tax expenditure reports but provide additional background information for the budget, such as Australia, Canada, Italy, UK, and the US. See OECD, *Tax Expenditures in OECD Countries* 69-132; International Forum on Tax Expenditures Weifang and others, *Tax Expenditures--Shedding Light on Government Spending through the Tax System Lessons from Developed and Transition Economies* 9-12.

[891] Li, *Legal Analysis of Tax Expenditure System* 25-27. See section 2.3.3 in Chapter 2.

[892] Ibid.

[893] Burton and Sadiq, *Tax Expenditure Management a Critical Assessment* 31-32.

[894] The US Government Accountability Office has a systematic assessment procedure for the evaluation of tax expenditures. The major evaluation criteria are as follows: what is the tax expenditure's purpose and is it being achieved? Even if its purpose is achieved, is the tax expenditure good policy? How does the tax expenditure relate to other federal programs? What are the consequences for the federal budget of the tax expenditure? How should the evaluation of the tax expenditure be managed? See United States Government Accountability Office, *Tax Expenditures: Background and Evaluation Criteria and Questions*, 2012) http://www.gao.gov/assets/660/650371.pdf.

[895] Kraan, 'Off-budget and Tax Expenditures' 71; Edgar, 'Financial Instability, Tax Policy, and the Tax Expenditure Concept' 969.

and evaluate tax incentives effectively and in a legalized way. It contains the basic procedural elements as a means of legal control, i.e. the legislative assessment, the government's accountability, and an evaluation that enables taxpayers to seek remedies.

(2) Necessity of tax expenditures in China

A tax expenditure system can increase transparency. The tax expenditure report, either as an annex to the budget or as an independent document, can increase the transparency and predictability of governmental expenditure on tax incentives. The transparency should not only be based on the legal basis but also on economic consequences and administrative procedures. [896] Taxpayers can rely on the documents to adjust their behaviors, and therefore they do not have to worry about sudden changes. For the government, it can better manage and supervise the revenue on a macro level. Furthermore, it contributes to the reduction or prevention of the discretionary granting of tax incentives by local governments, thereby creating a level playing field in domestic China. With respect to the WTO, the transparency of tax incentives can greatly assist China to fulfill its obligations in the WTO, especially the obligation of the subsidy notification to the WTO. Wang (2012) pointed out that a tax expenditure system is actually a legal framework balancing the interests between the state and taxpayers. On the one hand, it manages the state's fiscal revenue with the budget system, while, on the other hand, according to transparent budget reports, it protects taxpayer's legitimate expectations in relation to the benefits to be gained from those incentives. Thus, this legal system is beneficial for both the state and taxpayers.[897]

In addition, with such a legal control framework, it is easy to anticipate and evaluate the effectiveness and efficiency of adopted tax incentives. It relies on the establishment of a cost-benefit analysis and proportionality test. Normally, the granting of tax incentives bears different costs, including distortions between incentive receivers and non-receivers, forgone revenue, administrative resources, and the social costs of corruption or rent-seeking activities derived from abuse, etc. [898] If, before the granting of tax incentives, the tax authorities can evaluate all these costs and anticipate the relevant benefits generated, the targeting of certain tax incentives can be more clear and specific. Furthermore, the proportionality test helps to control the degree of tax

[896] Zee, Stotsky and Ley, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries' 1510.
[897] Wang, *On Legal System of Tax Incentives: Perspective for the Normative and Legitimacy Requirements of Law* 116-118 (in Chinese).
[898] Ibid 1501-1502.

incentives within a proper scope to achieve the objective. Furthermore, an ex-post assessment is beneficial for the authorities to supervise the effects of those incentives, so that they can terminate or extend incentives more flexibly.[899]

(3) Elements of a legal framework for tax expenditures

The procedural elements for designing a tax expenditure system include an ex-ante assessment of tax expenditures, a cost-benefit analysis, an ex-post assessment with the criteria of effectiveness and efficiency, proportionality test, transparent report, etc.[900]

When facing an investigation on the compatibility of a tax incentive with the WTO agreements, an important issue is the specificity of the tax incentives. Even when the granting of a tax incentive has undergone all the assessments in the tax expenditure regime, it can still constitute a subsidy under the ASCM due to its specificity, i.e. limited only to certain enterprises, industries, or regions, *de jure* or *de facto*. Tax incentives, in the form of tax expenditures, indeed are deviations from the tax system benchmark, but they do not have to be specific to certain recipients. Hence, it is important to emphasize that the tax expenditure system should also take into account the specificity of tax incentives. Despite the fact that they serve specific social or economic goals, they should not cause discrimination among recipients. This means that they should impact the level playing field as little as possible, and therefore the introduction of such a legal control system should take fair competition in the market as the main principle.

(4) Feasibility of tax expenditures in China

The legal control over tax incentives can be considered as a part of the rule of law process in China, which requires basic institutional and procedural elements that could support the system. The Chinese tax law system has developed in various ways, and therefore certain conditions are in place to satisfy those requirements. When matching the existing institutional elements in China with the basic conditions of the tax expenditure system, it is obvious to see the feasibility of introducing such a system to China.

a. Legislative elements

A tax expenditure system requires a regulation on the granting of tax incentives arbitrarily by the government, and therefore the power for granting tax incentives should be limited to legislative

[899] Burton and Sadiq, *Tax Expenditure Management a Critical Assessment* 55-58.
[900] Li, *Legal Analysis of Tax Expenditure System* 134-136.

authorities. The NPC is the supreme legislative entity in China. However, most tax incentives are granted by the MoF and the SAT, which are not in the form of official legislation. They do not really go through an ex-ante assessment or the assessment procedure is not transparent. Since China has legislative institutions and it also has a Budget Law, [901] it is feasible to include tax expenditures in the Budget Law or promulgate separate legislation or a regulation on tax expenditures. The most essential issue in this process is that an ex-ante assessment for the granting of tax expenditures is included.

b. Budget process

Tax expenditures in the form of a budget report require a budget process that could include tax expenditures. It not only requires subjects or authorities to be responsible for including the tax expenditures, but it also requires legislation that confirms the validity of such a process. With respect to China, the Budget law of China could form a basis for such a legal control. It regulates the powers for budget management, the scope of budgetary revenues and expenditures, budget compilation, examination and approval of budgets, implementation and adjustment, final accounts, supervision, and legal responsibility, etc.[902] However, the new amendment does not specifically take tax incentives into the legal regulation.[903] Nevertheless, it still provides a basis for including tax expenditure. Article 4 of the new Budget Law stipulates, "a budget consists of budgetary revenues and budgetary expenditure. All government revenues and expenditure shall be included in a budget". Tax incentives are also expenditures of government revenues, and therefore should be included in the budget. Additionally, the Budget Law also stipulates that the State Council is entitled to draft the central budget and final accounts and report to the NPC.[904] The NPC has the power to review and approve the central and local budgets.[905] The review procedure from the NPC should constitute an ex-ante and ex-post assessment for tax expenditures.

[901] Budget Law of the People's Republic of China (2014 Amendment). The Budget Law was promulgated in 1995 and was amended in 2014.
[902] Ibid.
[903] Article 27 stipulates that, by function, the expenditure in a general public budget includes expenditure on general public services, expenditure on diplomatic affairs, public security, and national defense, expenditure on agriculture and environmental protection, expenditure on education, science and technology, culture, health, and sports, expenditure on social security and employment, and other expenditure. It does not separate tax expenditure from other expenditures.
[904] Article 23, Budget Law of the People's Republic of China (2014 Amendment).
[905] Article 20, Budget Law of the People's Republic of China (2014 Amendment).

c. Administrative elements

A tax expenditure system requires administrative institutions that can implement and supervise the system. China has established a relatively mature administrative system for managing the tax expenditure system. Firstly, fiscal power is centralized at the central government level and is actually efficient for the administration of tax expenditures.[906] The central government is capable of coordinating the implementation of this system with the local governments. In addition, tax authorities have some experience in relation to the assessment of tax incentives. For instance, in certain projects of tax reductions or exemptions, the tax authorities have conducted a basic ex-ante and ex-post assessment, such as the immediate collection and immediate return of VAT.[907] With respect to the identification of tax expenditures, the existing approaches could continue. Three methods are at issue: automatic identification, identification after the assessment of tax administrations, and identification with the assistance of agents.[908] With these experiences, tax administrations could go further in the management of tax expenditures.[909]

d. Supervisory elements

An important characteristic of a tax expenditure system is an independent institution that could supervise the implementation of tax expenditures. It mainly involves an ex-post assessment, which evaluates the fairness, efficiency, and effectiveness of tax expenditures. To perform such an evaluation, the independence of the institution should be highlighted. It should be independent from the government who proposes and implements tax incentives. In China, the NPC and its standing committee has the supervisory power for tax expenditures, and the government has to report to the NPC.[910] Except for the NPC and its standing committee's supervision, the implementation of the budget, tax revenue and expenditure of governments are subject to independent auditing by the National Audit Office (NAO). As confirmed by the Constitution, the NAO is an independent auditing body that exercises its power of supervision in accordance with the law.[911] However, its independence is conditional, which is still subject to the overview of the

[906] Article 3, Law of the People's Republic of China on the Administration of Tax Collection (2015 Amendment).
[907] Li, *Legal Analysis of Tax Expenditure System* 132-133.
[908] Ibid 102-103.
[909] Ma, 'China's Current Tax Expenditure System: Issues and Policy Options' 199-202.
[910] Article 92, Constitution of the People's Republic of China (2004 Amendment).
[911] Article 91, Constitution of the People's Republic of China (2004 Amendment). The State Council established an auditing body to supervise, through auditing, the revenue and expenditure of all departments under the State Council and of the local governments at various levels and the revenue and expenditure of

Premier of the State Council. This means that it is still a department of the government, the State Council. At the local levels, local audit offices are departments of local governments. Therefore, the system is subject to the risk that the NAO will not be independent due to interference from its higher authority, the government. Nevertheless, it is an institution that could become a supplement to the NPC and its standing committee's supervision over tax expenditures, considering its experience and expertise in auditing. Further reform could focus on increasing its independence from the government.

e. Judicial elements

As a legal control procedure, the system should be guaranteed by judicial institutions.[912] Most countries that have the tax expenditure system also have evaluation procedures to examine the accountability of the government. Accordingly, there are approaches to remedies, which have two major tracks.[913] The first track is to seek administrative remedies by applying for administrative reconsideration within the administrative system. Since the granting of tax expenditures is a governmental administrative act, the direct remedy is towards the granting act itself. It has to emphasize that the institution responsible for administrative reconsideration is independent from the tax authority that implements the specific administrative act. The second track is a judicial remedy. It requires that there are independent courts that could deliver judgments and decide on compensation. Normally, in countries where a tax expenditure system exists, taxpayers have rights to administrative litigation against a government's action, and therefore judicial independence is a necessary condition for safeguarding taxpayer's rights.[914]

China has its own circumstances with respect to these judicial elements. Tax incentives are governmental administrative actions. Most tax incentives in China are issued by the SAT and the MoF in the form of regulatory documents, such as decisions and circulars. The main remedy mechanisms in China for administrative actions are administrative reconsideration and

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all financial and monetary organizations, enterprises and institutions of the state. Under the direction of the Premier of the State Council, the auditing body independently exercises its power of supervision through auditing in accordance with the law, without interference by any other administrative organ or any public organization or individual.

912 Yuwen Li, *The Rule of Law in China and Comparative Perspectives : Administrative Litigation Systems in Greater China and Europe* (Routledge 2016) 2.

913 Ibid 19-20.

914 Ma, 'China's Current Tax Expenditure System: Issues and Policy Options' 9-11; Randall Peerenboom, *Judicial Independence in China : Lessons for Global Rule of Law Promotion* (Cambridge University Press 2009) 24-26.

administrative litigation.[915] Plaintiffs may choose either of the two ways to seek a remedies. They could go to the administrative organ at the next higher level for administrative reconsideration or they could go directly to the courts.[916]

With regard to administrative litigation, the new amendment on Chinese Administrative Litigation Law (ALL) permits courts to review regulatory documents[917] when plaintiffs litigate against concrete administrative actions. Therefore, this provision endows on taxpayers the right to litigate against specific tax measures implemented by governments together with a claim for reviewing the legality of the regulation that such a tax measure relies on. It is considered to be an improvement which will contribute to increasing the government's accountability.[918] This provision provides the possibility to include legal remedies for establishing the legal system of tax expenditures.

However, direct litigation against administrative regulations or decisions or orders of general binding force will not be accepted by courts.[919] The rationale behind this is that these

[915] Administrative Reconsideration Law of the People's Republic of China (2009 Amendment) (ARL); Administrative Litigation Law of the People's Republic of China (2014 Amendment) (ALL). See also Li, *The Rule of Law in China and Comparative Perspectives : Administrative Litigation Systems in Greater China and Europe* 19-20.

[916] Ibid.

[917] See Article 53 of the ALL. Where a citizen, a legal person, or any other organization deems that a regulatory document developed by a department of the State Council or by a local people's government or a department thereof, based on which the alleged administrative action was taken, is illegal, the citizen, legal person, or other organization may concurrently file a request for review of the regulatory document when filing a complaint against the administrative action. The term "regulatory document" as mentioned in the preceding paragraph does not include administrative rules. For the English version of the ALL, see www.lawinfochina.com.

[918] As to the application of the ALL, the Supreme People's Court published an interpretation. Article 21 of the interpretation states a people's court shall not rely on an illegal regulatory document to determine the legality of an administrative action and shall state so in its legal reasoning. A people's court issuing an effective ruling shall provide the enacting authority of the regulatory document with recommendations and may also send copies to the people's government at the corresponding level or the administrative agency at the level immediately above. See Interpretation No.9 [2015] of the Supreme People's Court, 20 April 2015. For an English translation, see Chen Benjamin Minhao and Li Zhiyu, 'Interpretation of the Supreme People's Court on Several Issues Concerning the Application of "Administrative Litigation Law of the People's Republic of China"' (2016) 25 Washington International Law Journal 133. See also Chen Benjamin Minhao and Li Zhiyu, 'Explaining Comparative Administrative Law: the Standing of Positive Political Theory' (2016) 25 Washington International Law Journal 87, 116-117.

[919] Article 13 of the ALL. The courts shall not accept complaints filed by citizens, legal persons, or other organizations against the following: (2) administrative regulations and rules or decisions and orders with general binding force developed and issued by administrative agencies.

administrative regulations are stipulated by the State Council, which could be reviewed by legislative bodies through its supervisory system. As an independent supervisory institution, the NPC is capable of reviewing and annulling administrative regulations.[920]

As pointed out by some authors, there has been a long debate on the distinction between litigation against regulations or regulatory documents by governments at different hierarchies.[921] The provision assumes that a government's administrative actions will only harm individuals' rights through concrete administrative actions. Therefore, as the source of a concrete administrative action, such an administrative regulation could be reviewed by the courts.[922] However, if a plaintiff could not show that their rights are directly harmed by the general regulations themselves, they could not challenge the regulation directly. Supporters maintain that if plaintiffs could challenge a law or a State Council administrative regulation directly, there would be an abuse of such a right.[923] In addition, the courts in China, especially the lower courts, lack the resources and competence to solve such cases due to a lack of expertise and experience.[924] Moreover, the courts will not be able to handle the increased caseload. In contrast, opponents claim that legal guarantees are lacking in order to merely rely on legislative supervision.[925]

In summary, there are judicial elements to support the introduction of a legal control system in relation to tax incentives. The focus should be on how to consider legal remedies that could embed such a legal control into China's current judicial system.

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[920] There is no constitutional court in China. The NPC is the supreme organ that has the legislative supervisory power. Its standing committee has the power to annul those administrative rules and regulations, decisions or orders of the State Council that contravene the Constitution or the law. See Article 67 (7), Constitution of the People's Republic of China (2004 Amendment).

[921] Li, *The Rule of Law in China and Comparative Perspectives : Administrative Litigation Systems in Greater China and Europe* 22-23; Peerenboom, *Judicial Independence in China : Lessons for Global Rule of Law Promotion* 131-132.

[922] Taxpayers could also apply for administrative reconsideration. Article 7 of the ARL: if a citizen, legal person or any other organization considers any of the following provisions, which is the basis of a specific administrative act of an administrative organ, to be illegal, he or she or it may, when filing an application for administrative reconsideration on a concrete administrative act, file an application to the administrative reconsideration organ to review the provisions: provisions of departments under the State Council; provisions of local people's governments at or above the country level and their departments; provisions of people's governments of towns or townships.

[923] Peerenboom, *Judicial Independence in China : Lessons for Global Rule of Law Promotion* 94.

[924] Ibid 79.

[925] Li, *The Rule of Law in China and Comparative Perspectives : Administrative Litigation Systems in Greater China and Europe* 22.

7.2.2.2 Reference from EU State aid law: procedures and institutions

EU State aid law is originally a part of EU competition law, which was not designed for regulating tax incentives *per se*. However, it regulates selective tax aid that infringes fair competition in the internal market of the EU. As pointed out by some authors, State aid control is not a panacea that can be used to solve all the problems of tax competition. There is still space for the EU to limit the abuse of State aid law to combat the disadvantages of tax competition.[926]

However, if taking the objectives of maintaining a level playing field in the internal market as a standard for evaluation, State aid law is rather effective.[927] It has a systematic set of rules and procedures to control the harm of preferential tax incentives in the internal market. The system is a good example to show how well the procedural and institutional mechanism can play a role in protecting efficiency and equity in the market.

China is a unified country, but the EU is a supranational organization. In the EU, each Member State still has tax sovereignty. Thus, the starting point of the State aid regime is the common interest of the internal market, which is the common agreement between Member States. Obviously, the idea of the common interest is not applicable in China. Nevertheless, China has its own interests in its own market and its position in the international market. It is possible for China to refer to the State aid regime. What is more, the difficulties of implementing State aid control among EU Member States are likely not to cause concern for China, because it is easier to carry out reforms on its own tax system in a unified country.

(1) The identification of a tax aid

The State aid regime has relatively clear steps to identify a State aid measure, since it has provided a concrete definition of State aid. Additionally, there are Commission regulations and case law that assist in the actual identification of a State aid measure. Although the applicability

[926] Schön, *Tax Legislation and the Notion of Fiscal Aid-A Review of Five Years of European Jurisprudence*, available at SSRN: http://ssrn.com/abstract=2707049; Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 458-462; Edoardo Traversa, 'Tax Incentives and Territoriality within the European Union: Balancing the Internal Market witht he Tax Sovereignty of Member States' (2014) 6 World Tax Journal 332-337.

[927] For instance, the European Commission decided that selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands were illegal under EU State aid rules in 2015. On 19 May 2016, the European Commission published a Notice on the notion of State aid as referred to in Article 107 (1) TFEU. It explains how to identify tax rulings and tax settlements as State aid. For details, see footnote 21, 22 in Chapter 1.

of State aid law to taxation is evolving, it has to be acknowledged that it is effective in controlling the adverse effects of selective tax aid in the internal market. It has established a systematic procedure for the assessment of aid measures, which involves basic elements for tax expenditures.

What can be gained from this for China is that, when designing the tax expenditure system, it is necessary to provide a clear definition of a tax expenditure that is subject to legal enforcement. This concept should reflect that there is a deviation from the benchmark tax system in rendering tax benefits. It is also important to clarify the benchmark system or provide instructions on how to identify the benchmark system. Furthermore, since the design of such a tax expenditure system in China is in order to create fair competition in the market, it can refer to the notion of selectivity in State aid law so that the targets of regulating discriminatory specific tax incentives are clear. With respect to the identification of a tax measure's selectivity, the testing steps in the State aid regime are inspiring for China. There are three basic steps to determine selectivity. Firstly, fix a normal tax benchmark; subsequently, examine whether there is a deviation from the general benchmark; and lastly, determine whether the measure can be justified based on the nature or general scheme of the system. With these basic testing steps, the identification of specific tax incentives will become enforceable.

(2) Compatible State aid: the Commission's assessment

a. The ex-ante assessment

The State aid regime has taken into account the category of compatible State aid, which provides justifications for certain tax incentives under a balancing test.[928] The test enables the Commission to conduct an ex-ante assessment, so that it can effectively regulate the harmful effects of unlawful State aid. As introduced in Chapter 3, the Commission's assessment includes consecutive questions for the balancing test. Those questions actually embody the principle of proportionality, cost-benefit analysis, and transparency.[929]

[928] Section 3.4.2.2.3 the Commission's assessment of Chapter 3.

[929] The questions are 1. Is the aid measure aimed at a well-defined objective of common interest, like an efficiency objective, equity objective, or transition to better functioning markets? 2. Is the aid well-designed to deliver the objective of common interest, i.e. does the proposed aid address the market failure or other objectives? Is State aid an appropriate policy instrument? Is there an incentive effect, i.e. does the aid change the behavior of firms? Is the aid measure proportional, i.e. could the same change in behavior be obtained with less aid? 3. Are the distortions of competition and effect on trade limited, so that the overall balance is positive? 4. Is the aid transparent that Member States, the Commission, economic operators, and the public have easy access to all relevant acts and information about the aid? Ibid.

For China, when introducing the legal system of tax expenditures, it is inspiring to refer to this ex-ante assessment from the regulation of State aid. In the context of the EU, the balancing test takes the common interest of the internal market as the benchmark for balancing harms and benefits estimated by the aid measure. However, China could establish its own benchmark to design the ex-ante assessment.

As discussed in relation to the internal benchmark in Chapter 4, the concept of a level playing field is ambiguous. There can be different interpretations of fairness. Referring to the basic principle of equality which requires that those who are unequal to be treated unequally, and considering the special circumstances in China, to ensure a level playing field in China's market the regional disparities and the imbalanced development of industries should be taken into account. To ensure a level playing field *per se*, development of less developed regions and for those activities the market mechanism does not allocate the resources properly is required. For instance, R&D activities, environmental protection activities, big infrastructure projects, and the promotion of SMEs, etc. all must be supported. Therefore, it is possible to tax incentives in China that are justifiable, and therefore the balancing test for Chinese tax incentives should take into account the need for these regions and activities to be supported.[930] When evaluating the tax incentive, the objective of the measure should also be assessed. Afterwards, the proportionality test contributes to the cost and benefit analysis of the measure, thus determining whether the measure should be granted or not.

(2) The institution: the Commission

The institutional guarantee for the State aid control is the EU Commission. The complete and systematic controlling procedure provides the Commission with the power to administer and supervise the effect of aid measures. The Commission is not only the authority to conduct an ex-ante assessment on notified State aid, but it also has the power to investigate any tax measure provided by Member States that is likely to constitute State aid. Most importantly, it is an independent institution on the EU level, which has supremacy over Member States. Thus, its decisions are authoritative for Member States and may require them to adjust or regulate their tax measures. [931]

[930] Vanistendael, 'Fiscal Federalism, Are There Lessons to be Learnt for China?' 426-427.
[931] August Reinisch, *Essentials of EU Law* (Cambridge University Press 2012) 58-76.

China can be recommended to establish an independent authority, which has the power to assess and supervise tax expenditures. This authority should have legislative power that is at the highest level. In China's circumstance, the NPC is the supreme organ of state power, which has legislative power and supervisory power. It is an appropriate institution for controlling tax expenditures. The governmental branches of the SAT and the MoF could also be authorized institutions, which assist in the administration of tax expenditures.[932] Furthermore, independence of the authority is essential for assessing and supervising. If the NPC is the authority who decides on tax expenditures, there should be another independent auditing organ which supervises the implementation of tax expenditures. This organ should conduct ex-post assessment of tax expenditures and report to the NPC. Currently, there is no such institution in China, but it is recommended to set one up to guarantee that the system could really regulate tax expenditures.

b. Remedies

The remedies available in State aid law allow the Commission to carry out an ex-post assessment on the impact of aid measures, especially for unnotified new aid. on the Commission has an important advisory role when Member States intend to introduce specific tax aid measures, because once the measure is identified as a State aid, the beneficiaries have to return the benefits with interest. Moreover, the Court of Justice of the European Union (CJEU) acts as a supreme court of the EU, exercising judicial review over both the EU and Member States. It could review the legality of legislative acts of the Commission, which include regulations, directives, and decisions. The decisions of the CJEU are covered by the principle of the supremacy of EU law and therefore they must be followed by the Commission or Member States. Since it is an independent judicial institution, it has absolute authority.[933] The Commission and the Court always take a very strict attitude towards the recovery of incompatible aid. It makes the State aid regulation effective in reality and provides for a powerful legal control over the adverse effects of unlawful aid measures.

In China's circumstance, in the short term, there are concerns about implementing such a strict recovery of tax incentives. On the one hand, it requires the establishment of institutions to perform and supervise the enforcement of the recovery, which is costly. On the other hand, when involving

[932] Li, *Legal Analysis of Tax Expenditure System* 144-145.
[933] Reinisch, *Essentials of EU Law* 77-89.

tax issues, they can be technical and therefore the cases always require experts. At present, there is no tax court in China, and there are no real tax experts in the courts.[934] However, in the long run, it is necessary for taxpayers to have rights to litigate against harmful tax incentives that infringe fair competition in the market. Therefore, remedies in the form of recovery could be a powerful solution. Accordingly, there should be associated institutions, such as an independent supervisory authority and independent courts, which could assist in the implementation of the remedies.

7.2.2.3 Legal recommendations on the enforcement of the tax expenditure system

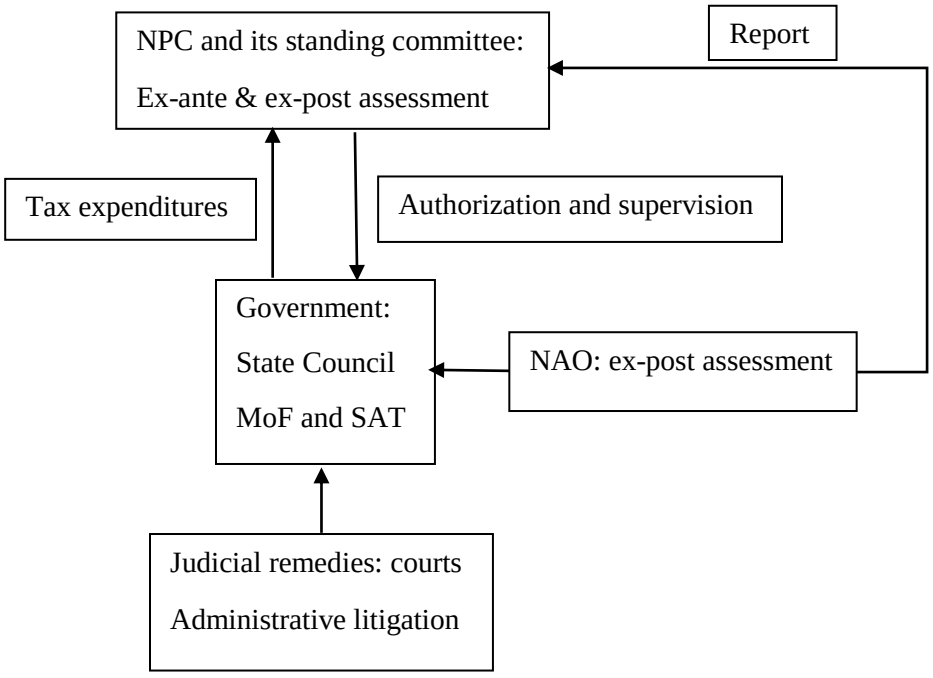

Chart 6

(1) Legislative elements

In order to ensure the legal enforcement of the tax expenditure system, it is suggested to embed tax expenditures into the Budget Law with amendments or to promulgate separate legal regulations.[935] This would subject tax expenditures to high legislative authority. In the short term,

[934] In fact, tax litigation is rather rare in China. Some authors attribute this phenomenon to the uncertainty and inconsistencies caused by the rapid changing tax laws and the abuse of discretionary power in tax administration. Yan Xu, 'Tax Dispute Resolution, Judiciary Independence and Property Rights' (2013 Summer Institute for Law and Economics, University of Chicago Law School); Cui, 'What is the Law in Chinese Tax Administration?'

[935] Xiong, 'Normative Research on the Cleaning up of Tax Incentives from the Perspective of the Rule of Law'166-167 (in Chinese).

including tax expenditures in the Budget Law could achieve the basic goal of implementing legal control. However, the Budget Law itself has to be amended in many respects, considering the complexity of stipulating all the relative provisions related to tax expenditures. It seems costly and time-consuming to implement such amendments. Thus, this way could work merely in a short term. In the long term, it is recommended to issue a separate regulation on tax expenditures, which could explicitly and comprehensively include all elements of the legal control.

With respect to the promulgation of a separate regulation on tax expenditures, in principle, the legislation should embrace the aim of creating a level playing field in the market. In addition, such an objective should fit China's circumstances, i.e. creating a level playing field in China's market. As a result, tax expenditures in China should not be specific to limited enterprises or regions. Nevertheless, as discussed previously, the market level in China differs from the international level with respect to its imbalanced economic development. Therefore, a level playing field should permit support for undeveloped regions and industries. This rationale is also justifiable under the EU State aid regime. When designing legislation on tax expenditures, it should take into account procedures for the approval of compatible tax incentives in China.

With regard to the content of the regulation, it should not only take into account the legal control elements, such as procedural and institutional elements, but it should also specify different institutions' responsibilities in order to enforce and supervise tax expenditures. Moreover, it should contain legal repercussions for the abuse of tax incentives. Once the tax expenditure system is enforceable according to the law, it could form a legal restriction for the government.

To be specific, the content of the regulation should include: (1) aim and principle of tax expenditures, with a guiding principle on creating fair competition in the market; (2) scope of the regulation, definition of a tax expenditure, and methods of identification; (3) allocation of powers between institutions, including legislative, administrative, and judicial institutions; (4) process of designing and approving tax expenditures, which should involve ex-ante assessment; (5) supervision and evaluation, which should include ex-post assessment; (6) responsibilities of each institution; (7) legal remedies; etc. The lawmaking is rather technical, which requires more expertise. This recommendation only depicts a framework containing essential elements that are necessary to form a legal regulation of tax expenditures.

(2) Institutional elements

With respect to the responsibilities of institutions, there should be an allocation of powers between different organs for the implementation of the tax expenditure system.[936] The body drafting the tax expenditures should be the government. As a part of the budget control, the drafting of tax expenditures should be in line with the overall budgeting process. The government is responsible for the budget. With respect to tax incentives, the MoF and the SAT can take the main role in drafting tax expenditures, since most previous tax incentives were issued by these two institutions. In addition, local governments and local bureaus of the tax administration could assist in drafting the tax expenditures by reporting local tax expenditure requirements to the central government.

The authorization power of tax expenditures should be with the NPC and its standing committee.[937] According to the Budget Law, the NPC and its standing committee are the organs responsible for the authorization of the budget. In order to strengthen the legal control on tax incentives, it is necessary to go through an ex-ante assessment by the supreme legislative authority. Even when promulgating a separate regulation on tax expenditures, the NPC and its standing committee should be the institution that evaluates and approves tax expenditures. Most importantly, the ex-ante assessment should embrace testing the specificity of the tax incentives, which could refer to the testing steps used in EU State aid law.[938] Furthermore, the assessment should also contain procedures that are subject to testing based on criteria of proportionality, effectiveness, efficiency, and transparency, etc. Specific assessment standards could be flexible according to the objectives of the tax expenditure system, but the assessment process itself should include these basic elements. If a tax incentive could satisfy the basic ex-ante assessment, the NPC and its standing committee could approve the granting of such an incentive. On the other hand, with regard to the authorization of compatible tax incentives, the NPC and its standing committee should rely on this ex-ante assessment procedure or the balancing test to make decisions on the compatibility of certain tax incentives.

[936] Wang, *On Legal System of Tax Incentives: Perspective for the Normative and Legitimacy Requirements of Law* 118-120.
[937] The NPC is the supreme organ of state power in China. See Section 4.1 Introduction in Chapter 4.
[938] See Reference from EU State aid law, the identification of a tax aid in Section 7.2.2.2.

With regard to enforcement and administration, the power should be in the hands of the tax administrations at different levels. Tax administrations, including state tax bureaus and local tax bureaus, are entities that are in charge of the collection of tax revenue.[939] They should be responsible for granting and managing the expenditures.

The supervising power can be divided into two parts. The first is external supervision from the legislative authority, the NPC and its standing committee. Independent from the government, the NPC and its standing Committee has the authority to conduct both ex-ante and ex-post assessments of tax incentives. In addition, the NAO could play a more important role in auditing tax expenditures independently. It is recommended to increase the power of the NAO that would enable it to audit tax expenditures and report directly to the NPC and its standing committee. Accordingly, it does not have to be subject to the interference of the government. The second part is the internal supervision by the tax administrations themselves, the higher tax authorities, the MoF and the SAT at a national level, could supervise local tax authorities. The main purpose of this internal supervision is to prevent local protectionism through the abuse of tax expenditures at the local level. With regard to the content of the supervision, an ex-post assessment is necessary. The design of the legal control system is based on the objective of creating a level playing field in China's market, and therefore it is necessary to evaluate tax expenditures after implementation to examine whether or not the incentive *de facto* harms fair competition in the market. Normally, tax incentives serve policy goals, and therefore it is logical to examine their effectiveness. Consequently, the NAO and the government should both report the implementation to the NPC and its standing committee. Accordingly, the NPC and its standing committee could publish reports on tax expenditures regularly.

(3) Judicial elements

The tax expenditure system, as a means of legal control, should also allow individuals and companies to have recourse to legal remedies against harmful tax incentives. When the governments illegally issue or implement tax incentives, individuals or companies are entitled to go to the court to make their claims.[940] Therefore, the court, as an independent and separate institution, makes a decision on the legitimacy of tax incentives. The law should clarify the

[939] Cui, 'Fiscal Federalism in Chinese Taxation' 461-462.
[940] Xu, 'Tax Dispute Resolution, Judiciary Independence and Property Rights'.

function of the court and remedies for the government's illegal actions in relation to tax expenditures. The ALL of China actually provides access to remedies for government's administrative actions. However, it has limits, as discussed previously. Therefore, with further a stipulation on remedies in the law, it would provide a direct guarantee for taxpayer's rights and legal control of government's actions.

(4) Practical concern: judicial independence for administrative litigation

As part of a legal control system, judicial remedies aim to ensure for the government's accountability. It requires that courts can independently decide cases on government's administrative actions. The ALL *de jure* stipulates that courts could review regulatory documents associated with a plaintiff's complaint on concrete administrative actions. However, it does not necessarily mean that courts *de facto* could make independent judgments.[941] Judicial independence is a very broad and vague concept that has no single model.[942] Nevertheless, it entails general ideas that judges have the ability to decide cases independently according to the law and without interference from other parties or entities.[943]

As observed by Peerenboom (2009), judicial independence could be reviewed from internal and external perspectives. Internal independence means judges could decide cases without interference from internal administrative hierarchy or senior judges. External independence refers to judges being able to decide cases without interference from external sources, such as the government, the military, or the society.[944] In China, as analyzed by some authors, the independence of the courts has been strengthened overall with respect to litigations in relation to administrative actions since the promulgation of the ALL in 1989.[945] From the internal perspective, appointments and promotions of judges are more merit-based, which gives more authority to the court. Judges could make decisions by resisting other forms of nonsystematic interference.[946] From the external

[941] Peerenboom, *Judicial Independence in China : Lessons for Global Rule of Law Promotion* 131-132.
[942] Ibid 71-72.
[943] Ibid.
[944] Ibid 71.
[945] Ibid 87-88, 129-132.
[946] Ibid 100-101.

perspective, studies show that, except for politically sensitive cases,[947] judges are generally able to make their own decisions, especially in relation to the outcome.

Nevertheless, there are still concerns with regard to the independence of judges in relation to administrative litigation on tax expenditures. The major influence is likely to be from the government, who is the defendant in such cases. This is especially a concern at the level of local courts, which are inclined to engage in local protectionism for local governments. The reason for this is that local courts are funded by local governments, and the human, financial, and material resources are controlled by the local authorities.[948] When accepting cases against local governments, local courts are less likely to be able to ensure independence from local governments. Additionally, local people's congresses could influence the independence of local courts as well, because the local people's congress has the authority to appoint and remove chief justices from office.[949] The standing committees of the local people's congress could supervise courts within their administrative jurisdiction.[950] Therefore, without reforming the relationship between the local courts and local governments and the relationship between local courts and local people's congresses, there can be concerns about the independent function of judges, particularly in undeveloped regions.[951]

In summary, if promoting the sustainable development of the market economy in China is the primary objective, it is necessary to introduce such a legal control system for tax incentives in order to maintain fair competition in the market. As a result, independent courts are essential legal guarantees for this system. The system has already been established, and therefore more reforms for establishing independent courts are expected.[952]

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[947] Politically sensitive cases are normally complicated and courts may be influenced from various sources. Thus, courts often limit access to such cases and steer disputes to other channels of settlement. See R. P. Peerenboom, *China Modernizes : Threat to the West or Model for the Rest?* (Oxford University Press 2007) 100-118.
[948] Keping Yu, *Democracy and the Rule of Law in China* (Brill 2010) 257-258.
[949] Article 101, Constitution of the People's Republic of China (2004 Amendment).
[950] Article 104, Constitution of the People's Republic of China (2004 Amendment).
[951] Yu, *Democracy and the Rule of Law in China* 261-265.
[952] Ibid 269-273; Peerenboom, *Judicial Independence in China : Lessons for Global Rule of Law Promotion* 92-94.

7.2.3 Recommendations at a micro level

In the long term, the introduction of an internal legal control over Chinese tax incentives could be an ideal solution to alleviate tensions. In the short term, the testing results demonstrate a potential incompatibility of specific tax incentives with the WTO's subsidy rules, and therefore there could be recommendations with respect to the specific issues.

Tax incentives with industry or region specificity are likely to constitute actionable subsidies under the ASCM, and thus it is recommended to modify or change them. These incentives cover two major governmental goals, i.e. support for R&D activities and for less developed regions. Support for R&D activities are tax incentives for high-tech enterprises, for the software industry and IC industry, and for animation enterprises. Assistance for less-developed regions are designed as tax incentives for the WDS and autonomous regions. Although China has its justifications for granting these incentives, under the current ASCM regime, without the existence of non-actionable subsidies, China could not find convincing justifications. However, if a tax expenditure system could be introduced in China, these tax incentives could be justified in the name of leveling the level playing field if they could not be in line with the ex-ante and ex-post assessment requirements.

The major issue exposed from the testing results is that SOEs enjoy *de facto* tax incentives. Tax incentives for SOEs are mainly determined by the dominating status of SOEs in China. They are likely to constitute actionable subsidies with enterprise specificity. As analyzed before, those tax incentives are *prima facie* granted to any enterprise participating in state-supported activities or industries and they are *de facto* beneficial to SOEs. The reason is that there is no market access for private or foreign investment in those state-supported areas.[953]

Under China's socialist market economy system, the status of SOEs is a factual situation, but the government's attitude towards SOEs is changeable. This is the place where legal regulations can play a role. Rules of fair competition should be applicable to SOEs as well. On 24th August 2015, the State Council issued a document on deepening the reform of SOEs.[954] It has confirmed further reform for developing mixed-ownership for SOEs by permitting and introducing non-state-

[953] See Section 4.2.3.3.1.2 *De facto* specificity.

[954] Zhongfa [2015] No.26, The Guiding Opinions on Deepening the Reform of State-owned Enterprises (the Guiding Opinions), by the Central Committee of the Chinese Communist Party and the State Council, 24 August 2015. See also 'China Urges SOE Modernization through Mixed Ownership Reform', *China Daily* (25 September 2015) <http://www.chinadaily.com.cn/business/2015-09/25/content_21979076.htm> accessed 13 May 2016.

owned investment into SOEs, especially in those industries usually limited to SOEs.[955] The investments can be diverse. Moreover, the document has introduced a classification of SOEs into two types, business oriented SOEs and non-profit-oriented SOEs. For business-oriented SOEs, more competition is encouraged. SOEs whose main business is in industries with full competition should introduce other types of investments ,whose main business is in the key industries and leading areas would maintain as holding shareholders, but should support non-state-owned capital participation.[956] The document indicates that the government's attitude towards SOEs could be changed. With the further opening of the market and the reform on SOEs, SOEs will not be the only beneficiaries of those tax incentives, because more and more private and foreign investments are able to conduct business activities in those areas as well. Therefore, it is necessary to abolish the favorable tax treatment for SOEs and let them compete with other enterprises on a level playing field.

7.3 Future of the WTO's subsidy rules

7.3.1 Reviving non-actionable subsidies

7.3.1.1 The WTO's tension with Chinese tax incentives: non-actionable subsidies

As analyzed before, the WTO is an outcome of the capitalist development. It is also a representation of the evolution of the relationship between the market and the government and the tensions arise here for China. The alleviation of tensions can not only rely on China's cooperation and reform. The WTO also has space for improvement if it hopes to function better. Returning to the research question, both the alleviation of tensions and a better position for China in international trade also require the WTO to also react at the same time.

The testing results demonstrate that the same Chinese tax incentives can have different compatibility results under the two systems. The main differences are due to the existence of compatible State aid, whereas non-actionable subsidies under the ASCM have lapsed.[957] Without the justification of non-actionable subsidies under the ASCM, Chinese tax incentives for autonomous regions and the Western Development Strategy (WDS), for R&D activities, and for environmental protection activities can all fall within the scope of actionable subsidies. It triggers

[955] Article 17 of the Guiding Opinions states that in the area of oil, gas, electricity, railway, telecom, resource exploration, public utilities, and the like, the government will promote and open projects for non-state-owned investments. Ibid.
[956] Article 4 and 5 of the Guiding Opinions. Ibid.
[957] See Section 4.3 Matrix of the testing results in Chapter 4.

a rethinking of the validity of non-actionable subsidies, if the creation of a level playing field is taken as the benchmark.

7.3.1.2 Basis for reviving non-actionable subsidies: the creation of a level playing field

As analyzed previously, the Aristotelian paradigm of treating unequals differently should be taken into account when defining the level playing field, but the question is how to ensure the unequal treatment avoids infringing equality itself. Rawls' ideal theory on the conceptualization of fairness can be a reference.[958] When discussing the external benchmark in Chapter 3, it was explained that there are two principles to understand fairness. Firstly, each person has the same indefeasible claim to a fully adequate scheme of equal basic liberties as is compatible with the same scheme of liberties for all. Secondly, social and economic inequalities must satisfy two conditions. They are attached to positions open to all under conditions of fair equality of opportunity, and they are to the greatest benefit of the least advantaged. The first principle should take priority over the second and, within the second principle, the first condition should take priority over the latter.[959]

When matching these principles with the WTO's subsidy rules, non-actionable subsidies could find some theoretical support. The creation of a level playing field actually means the first principle, which advocates equal opportunities for all participants in the market. The design of non-actionable subsidies actually reflects the second principle that addresses the issue of inequalities, with the purpose of realizing fairness. According to the second principle, if there are inequalities, such as if non-actionable subsidies were reinstated, they should favor the least advantaged. Regional subsidies for less developed regions can be a good example. The situation less developed regions not the same as in more developed regions, either economically or socially. If, without governmental intervention, the disparity between regions will continue to increase, it will thereby result in greater inequality. In order to create a level playing field, it makes sense to treat unequals differently. As some authors have contended, there are three ways to realize equality in this situation. Bring the worst-off and everyone in between up to the level of the best off; or bring the best off and everyone in between down to the level of worst off; or bring the worse off up and the better off down so that they meet in between.[960] In the context of regional subsidies, obviously

[958] Rawls, *A Theory of Justice* 4.
[959] Van Roermund, 'Fairness'.
[960] Pojman and Westmoreland, *Equality : Selected Readings* 5.

governments would like to bring the less developed regions up to the level of the best off. At least, they do not want to sacrifice the already developed regions just for the maintenance of fairness. Therefore, subsidies for less-developed regions are actually justified under the objective of fair competition. The same rationale applies to other types of non-actionable subsidies, including assistance for R&D activities and for adapting infrastructures to new environmental requirements. They are also likely to become least-disadvantaged areas for investment in the market due to market imperfections.[961]

7.3.1.3 Reference from EU State aid law: compatible State aid

Compatible EU State aid can be a reference to reconsider non-actionable subsidies. Under the EU State aid regime, there are three categories of compatible State aid which are exempt, disregarding their adverse effects, namely mandatory exemptions, discretionary exemptions, and the measures under the General Block Exemption Regulation (GBER).[962] Comparing the content of compatible State aid with non-actionable subsidies, it is easy to find that they are similar. The three types of non-actionable subsidies all have counterparts in the category of compatible State aid, and the State aid regime even contains more compatible measures. The main justification for compatible State aid is the community interest and the common objective of the internal market. Some authors therefore raise the point that non-actionable subsidies can also be reconsidered under the global community goals in the WTO.[963]

If non-actionable subsidies are to be revived, a consensus among scholars is that it is necessary to improve procedures in terms of transparency, proportionality, and the prevention of abuse in order to achieve best results.[964] To conduct the reform, EU State aid could become a point of

[961] See economic analysis in Chapter 2.
[962] See Section 3.4.2 Compatible State aid in Chapter 3.
[963] Robert Howse and Kalypso Nicolaidis, 'Enhancing WTO Legitimacy: Constitutionalization or Global Subsidiarity?' (2003) 16 Governance 73-94; Kyle Bagwell and Robert W. Staiger, 'Will International Rules on Subsidies Disrupt the World Trading System?' (2006) 96 American Economic Review 877-895.
[964] Sadeq Z Bigdeli, 'Resurrecting the Dead-The Expired Non-Actionable Subsidies and the Lingering Question of Green Space' (2011) 8 Manchester Journal of International Economic Law 36-37; Luca Rubini, 'ASCM Disciplines and Recent WTO Case Law Developments: What Space for 'Green' Subsidies?' (2015) 3 Robert Schuman Centre for Advanced Studies Research Paper No RSCAS 13-14; Robert Howse, 'Do the World Trade Organization Disciplines on Domestic Subsidies Make Sense? : the Case for Legalizing Some Subsidies' in Kyle. Bagwell, George A. Bermann and Petros C. Mavroidis (eds), *Law and Economics of Contingent Protection in International Trade* (Law and Economics of Contingent Protection in International Trade, Cambridge University Press 2010) 101-102; D. P. Steger, 'The Subsidies and

reference. Actually, State aid control is more effective due to the fundamental role of the European Commission. Except for *de minimis* aid and GBER, every Member State has the obligation to notify the Commission of any aid measure that is to be implemented. The Commission has to go through preliminary investigations and further formal investigations to assess whether the measure falls within the scope of mandatory or discretionary exemptions.

In contrast, the WTO lacks such a powerful institution to undertake stringent control of subsidies. Although Members in the WTO have the obligation to notify subsidies, the subsidy committee does not have a strict supervisory control over them, not to mention a stringent ex-ante assessment that is similar to the European Commission. Therefore, without a powerful entity to assess non-actionable subsidies beforehand, it is more significant to include certain and clear rules on the application of non-actionable subsidies.

Thus, the balancing test in the State aid assessment is also of value for the WTO. Similarly, the revival of non-actionable subsidies in the WTO could take into account the elements in the balancing test to ensure that this type of subsidy is not abused. However, the degree of the control still depends on how far Members in the WTO intend to reach in order to achieve fair competition. It is the key motivation behind the reform in relation to the multilateral disciplines.

7.3.2 Future of the WTO's role in relation to taxation

7.3.2.1 More influence of the WTO in relation to taxation

Although the WTO's subsidy rules are not aimed at regulating tax incentives, once they function as a controlling instrument, the rules can definitely be improved and clarified for better functioning.[965] Scholars always comment that subsidy rules are notoriously uncertain.[966] This is a

Countervailing Measures Agreement: Ahead of Its Time or Time for Reform?' (2010) 44 Journal of World Trade 794-796.

[965] Some authors suggest that the WTO must take greater responsibility to tackle tax problems associated with the development of international trade. The efficient way is to clarify and improve its present role on taxation through clarification and guidance in relation to tax provisions, and the establishment of a Committee on trade and taxation. See Farrell, 'The Interface of International Trade Law and Taxation : Defining the Role of the WTO 227-244; Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* 486-500.

[966] Rubini took public support to electricity as an example and listed uncertain parts of the subsidy rules: what amounts to a financial contribution? What is the status of tax incentives? What is status of "regulatory" measures? What does "any form of income or price support" actually mean? What does "benefit" mean? Is the specificity test really "specific"? How difficult is it to prove adverse effects? By listing these questions, he claimed that ambiguity must be permissive but not divisive. See Rubini, 'ASCM Disciplines and Recent WTO Case Law Developments: What Space for 'Green' Subsidies?'

general remark on the ASCM itself, which has not covered the issue on taxation. With respect to tax, the ASCM has only included tax subsidies in the form of export subsidies, which has a rather narrow application. It leads to the result that most tax incentives would fall within the scope of actionable subsidies, and would therefore be regulated by the general rules without specific reference to taxation. Thus, from the general rules to specific rules on tax subsidies, the ASCM lacks certainty and clarification that can guide Members' domestic tax policies.

7.3.2.2 Reference from the EU State aid law

a. Clarify the definition of subsidies

Most critics of the ASCM focus on the unclear definition of a subsidy. Although the ASCM has formulated testing steps for the identification of subsidies, they are still ambiguous, particularly when facing tax issues. In the definition of a subsidy, the ASCM fails to explain the notion of "the foregoing of government revenue otherwise due". When applying this provision to tax measures, Members always have their own interpretations, which are always different. Additionally, the key controversy is the identification of specificity. Despite the fact that the ASCM has classified enterprise, industry, and regional specificity, it lacks an interpretation of the same terms and fails to establish a test to identify them. For instance, the identification of regional subsidy is complex, since there are autonomous regions in many countries which have the authority to administer regional affairs. There are also distinctions between unitary and federal countries on the administration of regions. Without clear criteria to define regional specificity, it triggers more arguments when disputes occur.

In contrast, the State aid regime has provided more explanations on the notion of State aid, including identification methods for fiscal measures. Additionally, the case law in the EU has contributed to the clarification of these terms. State aid law has been applied in a large number of cases. With the expansion of State aid law to taxation, there are more cases involving tax issues.[967] Hence, the EU is able to compile those relevant cases and provide further clarifications on the application of State aid law. Furthermore, based on the development of case law, the Commission works efficiently on adding new interpretations, thereby guiding Member States more specifically.[968]

[967] Schön, *Tax Legislation and the Notion of Fiscal Aid-A Review of Five Years of European Jurisprudence*.
[968] The 2016 Notice.

Referring to the State aid law, the ASCM could work on its legal texts and offer a clearer definition of subsidies. The interpretations do not have to be the same as those in the EU, since the WTO has its own concerns, but nevertheless the EU's way of clarifying notions is inspiring. WTO law is also clarified by case law. There are many interpretations of provisions in a number of cases. Thus, the WTO can synthesize the opinions in those judgments as references or sources to provide further clarifications.

b. Tax subsidy rules

Another issue that can be referred to from the State aid regime is the promotion of separate tax subsidy rules, just as in the 2016 Notice that has taken fiscal measures into account.[969] The separate rules can not only give clear and certain definitions on tax subsidies, but they can also provide the steps for determining them. Compared to the fiscal State aid regime, an essential issue is whether or not to include compatible tax subsidies, i.e. non-actionable subsidies, into the rules. The overall State aid system has taken into account compatible situations, and thus the fiscal State aid regime coherently contains exceptional circumstances. If separate tax subsidy rules are to be implemented, it would be reasonable to think of including non-actionable tax subsidies. If so, the parameters of assessment in the State aid law can also become references for the new rules.[970]

c. A committee of tax experts

To enforce the rules, it is suggested to establish a committee composed of a group of tax experts who particularly solve tax subsidy disputes in the Dispute Settlement Body.[971] This committee could be a separate and independent entity in the DSB that handles disputes on tax subsidies. The methods for solving disputes could include discussions, negotiation, mediation, and final recommendations. The procedures are similar to the general dispute settlement procedures. The highlight of this committee is that it composes tax experts who have more expertise on tax issues, especially in cases of tax subsidies. Thus, they could settle tax-related disputes more efficiently.

[969] The 2016 Notice; Farrell, 'The Interface of International Trade Law and Taxation : Defining the Role of the WTO 230-231.

[970] It does not seem to be very realistic for the WTO to evolve this far towards the improvement of the rules, regarding the slow negotiation progress. See Rubini, 'ASCM Disciplines and Recent WTO Case Law Developments: What Space for 'Green' Subsidies?' 13-14; Howse, 'Do the World Trade Organization Disciplines on Domestic Subsidies Make Sense? : the Case for Legalizing Some Subsidies' 101-102; Steger, 'The Subsidies and Countervailing Measures Agreement: Ahead of Its Time or Time for Reform?' 794-796.

[971] Farrell, 'The Interface of International Trade Law and Taxation : Defining the Role of the WTO 227-244.

Moreover, as an independent committee, the committee's recommendations are authoritative. Members of disputes could rely on such an independent third party to mitigate conflicts. Considering the large membership of the WTO, tax experts of this committee should be selected from both developing and developed countries. Accordingly, the committee could provide an equal voice to developing and developed countries for solving disputes on tax subsidies.[972] Additionally, the committee can also become a consultative body for Members with respect to potential conflicts between domestic tax policies and subsidy rules. By providing technical assistance on tax subsidies, especially to developing countries, the committee contributes to preventing disputes on tax subsidies. The State aid system does not have such a separate body of tax experts who merely focus on fiscal aid measures. However, the European Parliament (EP) has formed temporary committees, i.e. the Special Committee on Tax Rulings and Measures Similar in Nature or Effect (TAXE Committee 1 &2) that files reports to the EP with the purpose of combating tax evasion and aggressive tax planning.[973] Moreover, the development of the case law might promote more functionality in this regard.[974]

7.3.2.3 China's role in the new process

The reposition of the WTO and even suggestions on the improvement of the current subsidy rules must take into account the multilateral circumstances in the organization. China could play a role in reshaping the rules. [975] The current rules not only fail to address sufficiently the concerns of developing countries in relation to tax competition, but they also do not take into account the requirement of a different economic system, namely China's socialist market economy.[976] Thus,

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[972] Althunayan, *Dealing with the Fragmented International Legal Environment-WTO, International Tax and Internal Tax Regulations* 229.

[973] The EP has established two special committees TAXE1 and TAXE2 to work on tax issues following public and political interests in advanced tax ruling practices in Member States. Both of the committees are temporary. TAXE1 started on 12 February 2015 and ended on 30 November 2015. TAXE2 started on 2 December 2015 and ended on 2 August 2016. The two committees filed reports on taxation to the EP during their existence. For information on TAXE1, see <http://www.europarl.europa.eu/committees/en/taxe/home.html> accessed 20 July 2016; for information on TAXE2 see <http://www.europarl.europa.eu/committees/en/tax2/home.html> accessed 20 July 2016.

[974] The European Commission's decisions on the increasing fiscal State aid measures demonstrate that the Commission is gaining more and more tax expertise to address fiscal State aid actions of Member States. See the Commission's decisions towards Starbucks, Fiat, Macdonald's and the like in footnote 21 and 22 of Chapter 1.

[975] H. Gao, 'Elephant in the Room: Challenges of Integrating China into the WTO System' (2011) 6 Asian Journal of WTO and International Health Law and Policy 163.

[976] Mark Wu, 'The WTO and China's Unique Economic Structure' in Benjamin L. Liebman and Curtis J. Milhaupt (eds), *Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism*

the reconsideration of tax subsidy rules should not only be driven and controlled by the few influential Western capitalist countries, but they should also involve China and other developing countries to announce their concerns.

7.4 Conclusion

This chapter aimed to answer the main research questions. On the one hand, it provides legal recommendations for Chinese tax incentives with respect to China's position in the international trade domain. On the other hand, it depicts the potential future developments for the WTO in relation to its subsidy rules and its role in taxation based on its interactions with China. For both China and the WTO, the EU State aid law could play a role in providing inspiration in developing the benchmarks of fair competition in the market.

For China, the basis for recommendations are the benchmarks derived in Chapter 3 and Chapter 4. The testing results reveal that there are tensions between Chinese tax incentives and the WTO's subsidy rules. The possibility to alleviate tensions relies on China changing its state-oriented attitude towards tax incentives by introducing an internal legal control over the granting of tax incentives. It is feasible because, under the socialist market economy system, the fundamental market rules should also be applicable in China. Thus, it is the requirement of China's market system to create a level playing field for domestic competition. In addition, with China's further integration into the world economy, it is necessary for China to adjust itself into a proper position to participate in the competition at an international level, namely under the WTO's framework, which requires fair competition.

The main recommendations for Chinese tax incentives are at a macro level, which suggest to introduce the tax expenditure system in China. One way to do this is to include the granting of tax incentives into the budget process or to promulgate separate regulations on tax incentives. The EU State aid law could become a reference point considering its effectiveness in achieving the law's objectives. On the one hand, the State aid regime provides a relevant clear notion of State aid, especially fiscal State aid. It contributes to the identification of a tax aid measure. On the other hand, it has a systematic controlling procedure that guarantees the implementation of the law. The procedure includes an ex-ante assessment, which contains all the necessary elements required by

(Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism, Oxford University Press 2015) 343-345.

a tax expenditure system. Moreover, it has an independent and authoritative institution, the European Commission, which is delegated with the power to enforce the law. Another feature of State aid law is its remedies. Its authoritative position in relation to the Member States makes the law rather effective to safeguard the level playing field in the internal market.

The concrete recommendations for China are to embed tax expenditures into the Budget Law or to promulgate separate legal regulations on tax incentives. The legislation should embrace the aim of creating a level playing field in the market, and therefore it should take into account procedures for the approval of compatible tax incentives in China. With regard to the content of the legislation, it should not only contain the legal control elements, such as procedural and institutional elements, but it should also clarify different institutions' responsibilities. Therefore, there should be an allocation of powers between different organs to implement the tax expenditure system. The government, including the MoF and the SAT, could be the drafting body of tax expenditures. The NPC and its standing committee should authorize and supervise the tax expenditures. They have to go through ex-ante and ex-post assessments of tax expenditures, which should include evaluations on specificity, effectiveness and efficiency, proportionality, and transparency of tax expenditures. Moreover, to implement the law, there should be an allocation of powers among different organs to conduct and supervise the enforcement of the legal control. Accordingly, citizens and companies should have access to legal remedies against harmful tax incentives. Tax administrations at different levels should be responsible for the enforcement and administration of tax expenditures. Moreover, with respect to the supervising power, except the supervision from the NPC and its standing committee, the NAO could play an increasing role as an independent auditing organ to conduct an ex-post assessment of tax expenditures. Within the tax administrations, the national tax authorities could also supervise the local tax authorities. There should be remedies for tax incentives as well. The legislation should clarify the access to courts for administrative litigation for remedies for tax expenditures. Nevertheless, there are practical concerns with regard to judicial independence in administrative litigation, especially at local levels due to local protectionism. More reforms are expected to promote the independence of courts.

There are also recommendations at a micro level, which focus on tax incentives for R&D intensive industries, for less developed regions, and for SOEs. These tax incentives are likely to constitute actionable subsidies under the ASCM. If China aims to avoid disputes with other

Members of the WTO on the issue of tax incentives as subsidies, it should take legal actions against the specific tax incentives granted to these industries or regions, especially *de facto* incentives provided to SOEs. With the further integration into the world economy, it is important to provide fair treatment to foreign and private enterprises, compared to SOEs.

For the WTO, it is also inspiring to rethink the subsidy rules and its role in relation to taxation. It could rethink reviving the category of non-actionable subsidies and establish more specific rules for taxation measures. The testing results reveal that some Chinese tax incentives, including tax incentives for autonomous regions, for the WDS, for R&D activities, and for environmental protection activities, could be justified under the EU State aid system due to the existence of the category of compatible State aid. However, under the WTO's subsidy regime, the lapse of non-actionable subsidies makes those tax incentives actionable. Referring to the objective of creating a level playing field, the interpretation of fairness actually supports the reviving of non-actionable subsidies. According to Rawls' theory on justice, inequalities should benefit the least-advantaged in the society. Assistance for R&D activities, for disadvantaged regions, and for adapting infrastructures to new environmental requirements could fall within the scope in the context of business investment in the market. When reconsidering non-actionable subsidies, EU State aid regime can be a reference point as well, especially the compatible State aid category. Furthermore, considering the WTO's influence on tax competition, it is better to establish very clear legal rules for tax subsidies. Although its does not aim specifically at regulating tax subsidies, it functions as a powerful institution to influence Members' tax policies. With respect to subsidy rules, it could clarify the definition of subsidies, especially in terms of taxation. On the other hand, it could form a committee composed of tax experts to address tax disputes. Therefore, the EU State aid regime also has factors to refer to. During the progress of reshaping the WTO's role in taxation, China could play a more important role in promoting this process.

Chapter 8 Summary and Conclusions

8.1 Introduction

This research started with the aim of analyzing the relationship between Chinese tax incentives and the subsidy rules of the WTO against the background of EU State aid law. China, as a Member of the WTO, encounters trade disputes towards its tax incentives in the WTO. There are tensions between specific Chinese tax incentives and the WTO's subsidy rules. Considering the similarity of the EU State aid law with the WTO's subsidy rules, a comparative analysis from the EU State aid law perspective contributed to a better understanding of this issue. In the context of the tensions, the research intended to provide recommendations for the alleviation of the tensions by answering the two main research questions:

What is and what should China's position be towards tax incentives in the international trade domain based on comparative studies between subsidy rules of the WTO and EU State aid law?

What should the WTO's position be towards China and taxation with respect to subsidy rules based on the studies on Chinese tax incentives and EU State aid respectively?

To answer the main research questions, the research raised several sub-questions and embedded them into each chapter. Chapter 2 provided a basic economic analysis on the rationale for granting and regulating tax incentives as subsidies. Chapter 3 introduced the WTO's subsidy rules, the EU State aid law, and their relation with and application to taxation. An external benchmark was derived from the common objects and purposes of the two legal systems. Chapter 4 was an introduction to Chinese tax incentives. It developed an internal benchmark based on China's domestic market system. Chapter 5 conducted a comparative testing of specific Chinese tax incentives against the WTO's subsidy rules and EU State aid respectively. Chapter 6 analyzed the tensions between Chinese tax incentives and the WTO's subsidy rules based on the testing results. It further explored the origins of the tensions from the perspective of history, economic thoughts, and culture. Chapter 7 provided legal recommendations for Chinese tax incentives and the WTO's subsidy rules to alleviate the tensions, thus answering the research questions.

This last chapter is a summary of the whole research and presents conclusions to the research questions.

8.2 Summary of the research

8.2.1 Tax incentives as subsidies in the context of international trade and competition: rationale for granting and regulating

The context of this research is international trade and competition. Under the market economy system at an international level, the staring points are efficiency and equity in the market. In order to maintain a well-functioning market system, it is necessary to establish a level playing field in the market. Governments always use tax incentives as subsidies to achieve different economic or social objectives. It is a way of governmental intervention into the market. The analysis on the effects of tax incentives demonstrates that they can play a role to realize governmental goals, such as correcting market failures, supporting infant industries, stimulating exportation, attracting FDI, and improving equality. However, they cause harmful effects as well. Tax incentives for the correction of market failures can cause more welfare losses and new failures; tax incentives for the support of infant industries can prompt them to become monopolists in the market; export subsidies could trigger subsidy competition and a race to the bottom; tax incentives for improving equity actually is discriminatory. Therefore, in order to guarantee efficiency and equity in the market, it is essential to control the use of tax incentives as subsidies. Moreover, considering the transnational effects of tax incentives, it is necessary to regulate tax incentives at an international or supranational level. This regulation should be in the form of the rule of law, which normally entails an ex-ante and ex-post assessment of tax incentives.

8.2.2 Subsidy rules of the WTO and State aid in the EU

The WTO is the world's most influential trade organization, which has specific legal regulations on subsidies, the ASCM. The EU, as a supranational organization, also has a stringent internal subsidy regime, State aid law. They have their own systems to regulate tax incentives as subsidies. The two legal systems on the regulation of subsidies include the requirement of the market economy. Thus, the research derives an external benchmark from the common objects and purposes of the two systems, which is a basis of providing recommendations for Chinese tax incentives and the WTO's subsidy rules. The external benchmark is the creation of a level playing field for competition in the international market by regulating the abuse of governmental subsidies. Under this common objective and purpose, the two legal systems have similarities in identifying subsidies. However, a comparative study shows that EU State aid law develops further since it takes into account compatible State aid based on the rationale of equity and a strict procedure for ex-ante assessment. It also entails strict remedies that make the law more effective.

8.2.3 Chinese tax incentives

The introduction on Chinese tax incentives has two parts. The first part provides a chronological review on the evolution of direct tax incentives in China. The time span is from the establishment of the PRC to the promulgation of the EIT Law in 2007. The historical review introduces the "rise and fall" of tax incentives for FDI in China. It shows China's changing attitude towards tax incentives, from arbitrarily using them to attract FDI to gradually reducing and regulating the use of them with China's integration into the world economy.

In such a context, an internal benchmark is also developed for the evaluation of China's granting of tax incentives. It justifies the creation of a level playing field for competition in China's domestic market, which is under a socialist market economy system. There are differences and similarities between China's socialist market economy and the Western market economy. The main difference is the relationship between the state and the market. In China, the market operates under the framework of the state and the state has more power to intervene in the market. State ownership is the leading force of the economy, and therefore there is limited access for private ownership in certain areas. Nevertheless, the market system shares similarities with the Western counterpart. The protection of private ownership and the respect for an individual's choice are the fundamental issues for the market. These basic market rules should also be applicable in China's market. Therefore, it is the market's own requirement on efficiency and equity to create a level playing field for competition in China. Moreover, the internal benchmark shares the same essence with the external benchmark. The interpretation of a level playing field should take into account the principles of equality and of proportionality. Thus, when evaluating Chinese tax incentives against the benchmarks, it should consider regional disparities and the imbalanced development of industries in China's current circumstances.

The second part introduces the present tax incentives in China, including corporate tax incentives and VAT incentives. They are classified according to the criteria of industrial and regional specificity, which are the main criteria to identify a subsidy in the WTO or a State aid in the EU. The main corporate tax incentives are for high-tech industries, SLEs, environmentally friendly projects, and specific regions. The VAT incentives have been introduced against the background of transforming BT to VAT. The present VAT incentives actually focus on the same industries or regions that enjoy corporate tax incentives.

8.2.4 Testing of Chinese tax incentives against the ASCM and EU State aid law

Following the testing steps summarized in the ASCM and the EU State aid law respectively, the testing results demonstrate that certain Chinese tax incentives are likely to constitute subsidies, particularly actionable subsidies, under the ASCM in the WTO. The industry or enterprise specific tax incentives are for high-tech enterprises, for software industry and IC industry, for animation enterprises, and energy-saving service enterprises. The regionally specific tax incentives are for autonomous regions, the WDS, the CEZs, and the FTZs. In addition, SOEs are *de facto* the main beneficiaries of tax incentives for state-encouraged public infrastructure facility projects.

In contrast, the comparable testing in the State aid regime shows different results. Due to the existence of compatible State aid, some actionable subsidies could be exempted from being identified as State aid if certain conditions are satisfied. They include tax incentives for R&D activities in high-tech enterprises, software industry and IC industry, for energy-saving service enterprises, for autonomous regions and the WDS. When assessed against the external benchmark, it is clear to conclude that certain tax incentives, such as those for less-developed regions and for SLEs are actually used to achieve a level playing field. Thus, these tax incentives could be justified under the benchmarks.

8.2.5 The origins of tensions between Chinese tax incentives and the Western standards

The testing results on the incompatibility of certain Chinese tax incentives reflect deeper tensions between China's attitude towards tax incentives and the WTO's subsidy system and the EU State aid regime respectively. China has a state-oriented attitude towards tax incentives and there is a lack of internal legal control in relation to the granting of tax incentives. In contrast, the Western systems operate under a market-oriented system, which requires legal control over the government's intervention into the market. Hence, the granting of tax incentives is regulated by the Western systems.

Different origins explain the tensions from the perspective of China's path and the Western path. The starting point of understanding the Western market-oriented system is acknowledging that it is outcome result of the development of capitalism. In the evolution of the relationship between the market and the government, the market still plays a decisive role in the allocation of resources and the government intervenes when necessary. The modern state is also a result of the development of capitalism, since it requires a powerful government to protect individual rights and to serve the public good. With respect to the Western legal regulation on subsidies, it has to

be emphasized that the Western systems are based on the rule of law. Regardless of the diverse theories on the rule of law, the rule of law in the Western systems aims to limit the arbitrary use of state power and to protect the market order. From the angle of cultural analysis, Western culture is behind the development of the market-oriented system and the respect for the rule of law. These cultural elements include the Western philosophies of being realistic and the respect for fair competition and cooperation, etc.

In contrast, China's state-oriented attitude towards tax incentives and the lack of internal legal control over the granting of tax incentives also have their origins in history. In the time of socialist China, before the Reform and Opening, China had a planned economy. There was no free market and the state had absolute control over taxation. With respect to the state's function, the state only used taxation as an instrument to realize its allocation of resources. In addition, influenced by Marxism, taxation and law were considered as part of the superstructure, which was subordinate to the economy. They were only used as instruments to achieve economic goals. After the Reform and Opening, China introduced a market economy, but the state still had macro control over the whole economy. SOEs are leading forces of the economy, and therefore they have more tax preferences from the government. China also attempted to establish a socialist rule of law system which promoted reforms in various areas. However, there is still a lack of legal control over the granting of tax incentives. In the time of traditional China, it was an agricultural country that was under the policy of pro-agriculture and anti-commerce and there was no free market. The state was an emperor's state, which served the emperor's rule. There was no separation between the emperor's personal income and expenditure with the state's. The law was only an instrument of the emperor, and therefore the rule of law was not in the sense of the West. In addition, there was a cultural factor to understand China's state-oriented style, i.e. Confucianism. By advocating for humanity and self-cultivation through virtue and ritual, Confucianism actually supports a highly organized government under the ruler in traditional China. Although in socialist China, Confucianism was modernized, its revival was still oriented by the government with the purpose of maintaining a harmonious social order. Moreover, the philosophies of Confucianism underline the adaption and adjustment to the environment and the world, rather than going against them. It contributes to the understanding of the formation of a paternalistic government in China.

8.3 Conclusions and recommendations

It is possible to find a common platform to alleviate tensions by returning to the benchmarks. To answer the research questions, there are legal recommendations for Chinese tax incentives with respect to its position in the international trade domain. In addition, the research depicts the potential developments for the WTO in relation to its subsidy rules and its role in taxation.

For China to alleviate its tensions with the WTO, it has to change its state-oriented attitude toward tax incentives by introducing an internal legal control over the granting of tax incentives. Returning to the benchmarks established in this research, it is a requirement of the market operation under China's market system to create a level playing field for domestic competition. Furthermore, with China's further integration into the world economy, it is necessary for China to adjust to a position that enables it to participate in international competition more fairly. Therefore, the main recommendations for Chinese tax incentives at a macro level is the introduction of a tax expenditure system which includes the granting of tax incentives into the budget process or promulgates separate regulations on tax incentives. The EU State aid law could be a reference given that it is effective to achieve the objective of maintaining fair competition in the internal market. To be specific, it is recommended for China to embed tax expenditures into the Budget Law or to promulgate separate legal regulations on tax incentives. The law should include an ex-ante and ex-post assessment, cost-benefit analysis, evaluation on effectiveness and efficiency, proportionality test, and transparency report, etc. Moreover, to implement the law, there should be an allocation of powers among different organs to conduct and supervise the enforcement of the legal control. Accordingly, citizens and companies should have access to legal remedies against harmful tax incentives. The recommendation at a micro level is to take legal action against specific tax incentives granted to R&D intensive industries, to regions, and *de facto* to SOEs, considering their possibility of constituting actionable subsidies under the ASCM.

For the WTO, it could also play a role to alleviate the tensions with China. It is suggested to rethink reviving the category of non-actionable subsidies and making more specific rules in relation to taxation. According to the benchmarks, the creation of a level playing field supports the reviving of non-actionable subsidies. Assistance for R&D activities, for disadvantaged regions, and for adapting infrastructure to new environmental requirements could find theoretical support from the interpretation of the benchmarks. Similarly, the EU State aid could become a reference point, especially the compatible State aid. With respect to the WTO's role in taxation, it could

improve its subsidy rules relevant for taxation, since its plays an essential role in influencing Members' tax policies. It could clarify the definition of tax subsidies and the steps of their identification. Moreover, it could form a committee composed of tax experts to address tax disputes. The EU State aid law could be a reference point in certain aspects as well. China could play a more important role in this process.

In conclusion, the evolution of Chinese tax incentives, the WTO's subsidy rules, and the EU State aid law are in flux. On the issue of tax incentives, China has a long way to go. The WTO's requirement and the EU's inspiration offer China new opportunities to march towards a more legitimate system. If further integrating into the world economy is the trend, China has to prepare for a more open market with an internal legal control over its tax incentives. Simultaneously, as an emerging power, China should also find its own way of establishing a legal system for tax incentives, thus gaining a better position in the international trade domain. Furthermore, to create a better international trade environment, the WTO, the world's largest trade organization, has to review its legal system according to the practical needs. At present, the EU appears to be more developed in terms of its legal framework for controlling tax incentives, and therefore, it could provide inspiration.

Appendix I: Matrix of subsidy investigations against China in the WTO

Dispute number	Case title	Filing date	Compliant(s)	Settlement status
DS309	China-Value-Added Tax on Integrated Circuits	18 March 2004	US	Mutually agreed solution
DS339, DS340, DS342	China-Measures Affecting Imports of Automobile Parts	30 March 2006	US, EU, Canada	Full compliance
DS358, DS359	China-Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments	2 February 2007	US; Mexico	Mutually agreed solution
DS387, DS388, DS390	China-Grants, Loans and Other Incentives	19 December 2008	US; Mexico; Guatemala	Mutually agreed solution
DS414	China-Countervailing and Anti-Dumping Duties on Grain Oriented Flat-rolled Electrical Steel from the United States	15 September 2010	US	Full compliance
DS419	China-Measures Concerning Wind Power Equipment	22 December 2010	US	In consultations
DS427	China-Anti-Dumping and Countervailing Duty Measures on Broiler Products from the United States	20 September 2011	US	Full compliance
DS440	China-Anti-Dumping and Countervailing Duties on Certain Automobiles from the United States	5 July 2012	US	No further action required
DS450	China-Certain Measures Affecting the automobile and automobile parts form the US	17 September 2012	US	In consultations
DS451	China-Measures Relating to the Production and Exportation of Apparel and Textile Products	15 October 2012	Mexico	In consultations
DS489	China-Measures Related to Demonstration Bases and Common Service Platforms Programs	11 February 2015	US	In consultations

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